

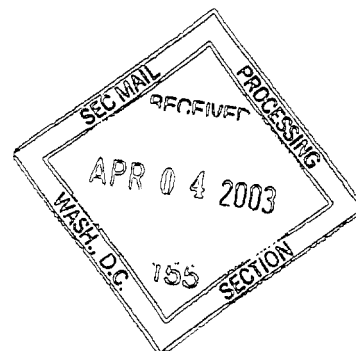


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*FIRST
KEYSTONE
CORPORATION*

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ANNUAL REPORT 2002

The Corporation

First Keystone Corporation is a bank holding company incorporated under the Pennsylvania Business Corporation Laws. Its assets consist primarily of the assets of its wholly-owned subsidiary, The First National Bank of Berwick.

The First National Bank of Berwick serves Columbia, Montour, and Luzerne Counties. The Bank engages in general banking business and also provides fiduciary services.

Corporation's Annual Report and Form 10-K

A copy of the Corporation's Annual Report and Form 10-K, as filed with the Securities and Exchange Commission, will be furnished upon request. Address requests to:

J. Gerald Bazewicz, President
First Keystone Corporation
P. O. Box 289
Berwick, PA 18603-0289
Telephone: (570) 752-3671

Annual Meeting

The Annual Meeting of shareholders will be held on April 15, 2003, at 10:00 a.m. The location will be at the Main Office of The First National Bank of Berwick, located at 111 West Front Street, Berwick, Pennsylvania.

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SUMMARY OF SELECTED FINANCIAL DATA

(Amounts in thousands, except per share)

	2002	2001	2000	1999	1998
SUMMARY OF OPERATIONS					
Interest income	\$ 25,862	\$ 26,836	\$ 25,650	\$ 23,172	\$ 20,703
Interest expense	11,342	14,465	13,995	11,888	10,329
Net interest income	14,520	12,371	11,655	11,284	10,374
Provision for loan losses	550	610	425	325	275
Investment securities gains (losses)	29	278	113	124	179
Net income	6,587	5,433	5,208	5,160	4,888
PER COMMON SHARE					
Net income	\$ 2.22	\$ 1.83	\$ 1.75	\$ 1.71	\$ 1.59
Cash dividends	.85	.77	.73	.67	.56
BALANCE SHEET DATA					
Assets	\$ 439,526	\$ 393,472	\$ 360,342	\$ 333,516	\$ 303,028
Investment securities	215,755	184,107	156,438	135,031	130,686
Net loans	198,343	195,302	187,969	182,631	159,112
Deposits	330,745	294,681	271,473	244,680	247,092
Stockholders' equity	49,096	39,696	36,658	29,358	33,753
PERFORMANCE RATIOS					
Return on average assets	1.59%	1.41%	1.52%	1.58%	1.72%
Return on average equity	14.93%	13.85%	16.55%	16.12%	14.68%
Dividend payout ratio	38.33%	42.24%	41.90%	38.72%	35.32%
Average equity to average assets ratio	10.66%	10.16%	9.20%	9.78%	11.72%

To Our Shareholders

It is my pleasure to report on another excellent year for First Keystone Corporation and its subsidiary, The First National Bank of Berwick. Net income reached a new record level of \$6,587,000 for the year ended December 31, 2002, marking the 20th consecutive year that earnings have increased. Earnings per share were \$2.22 in 2002 as compared to \$1.83 in 2001, an increase of 21.3%. Our profitability ratios improved with return on average assets of 1.59% in 2002, up from 1.41% in 2001, and return on average equity of 14.93% in 2002, up from 13.85% in 2001. With the improvement in earnings, cash dividends paid per share were increased to \$.85 in 2002, up from \$.77 in 2001, an increase of 10.4%.

During 2002, we experienced excellent balance sheet growth with total assets of \$439,526,000 as of December 31, 2002, as compared to \$393,472,000 at year end 2001, an increase of 11.7%. Likewise, total deposits increased to \$330,745,000 as of year end 2002 from \$294,681,000 in 2001, an increase of 12.2%. The continued decline in interest rates during 2002 did little to help our weakening national economy. As a result, loans, net of unearned income increased to \$201,517,000 as of December 31, 2002, from \$198,224,000 in 2001, an increase of only 1.7%. Fortunately, we did not see an increase in problem loans which is normally the case with a slowing economy. Actually, our loan quality has remained satisfactory with loan losses and non-accrual loans at year end 2002 below the totals reported in 2001. Additional details on our loan portfolio and related financial information may be found in the Management's Discussion and Analysis section of this Annual Report.

The decrease in interest rates and our accompanying decline in our cost of funds, resulted in an improved net interest margin of 3.95% in 2002 as compared to 3.63% in 2001. This was the primary impetus for our record earnings year in 2002. We saw some tightening of our net interest margin in the fourth quarter of 2002 with the final 50 basis points reduction in short-term interest rates by the Fed. Our greatest concern for 2003 is the uncertain economy and what, if

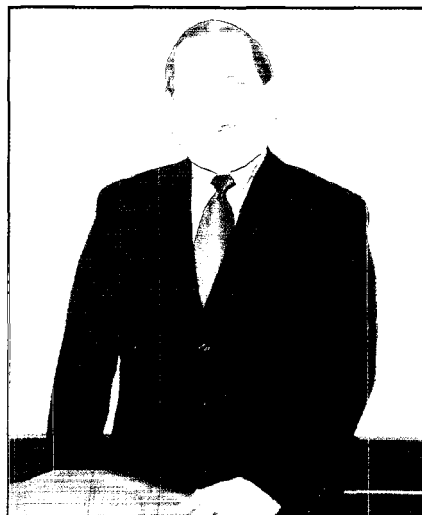
anything, will happen to interest rates during the year. We continue to work on positioning First Keystone Corporation to be prepared for whatever interest rate environment unfolds, based on the tug of good economic news versus bad economic news.

If you recall in my letter to shareholders in last year's 2001 Annual Report and also in the 2000 Annual Report, I mentioned that we believed that First Keystone Corporation and other bank stocks represented attractive long-term investments. Well, our stock performance has been outstanding in the past two years. First Keystone Corporation stock had total return of 29.2% in 2001 and 44.3% in 2002. This takes into account both dividends and capital appreciation and assumes the reinvestment of dividends into additional shares in both years. Remember, we do have dividend reinvestment available where you can reinvest all or part of your present cash dividends. Also, if you are a participant in dividend reinvestment, you can take advantage of optional quarterly cash contributions for the purchase of additional shares of First Keystone.

The principal subsidiary of First Keystone Corporation, The First National Bank of Berwick, has served the financial needs of both individuals and businesses since 1864. Our remarkable history of 138 years and counting, makes The First National Bank of Berwick unique. Our history is deeply rooted in the tradition of providing outstanding customer service while making important contributions to the communities in which the Bank does business. We remain committed to the communities we serve and quality customer service. As shareholders, you should know that our commitment to community and customers, as well as our commitment

to employees and shareholders, will continue to be the foundation for growth in 2003 and into the future.

As such, we thank the untiring efforts of our employees, officers, and our Board of Directors. Thank you also, to our shareholders and customers for your loyalty, support, and continued confidence. As always, we welcome any comments or suggestions you may have to make us even better.



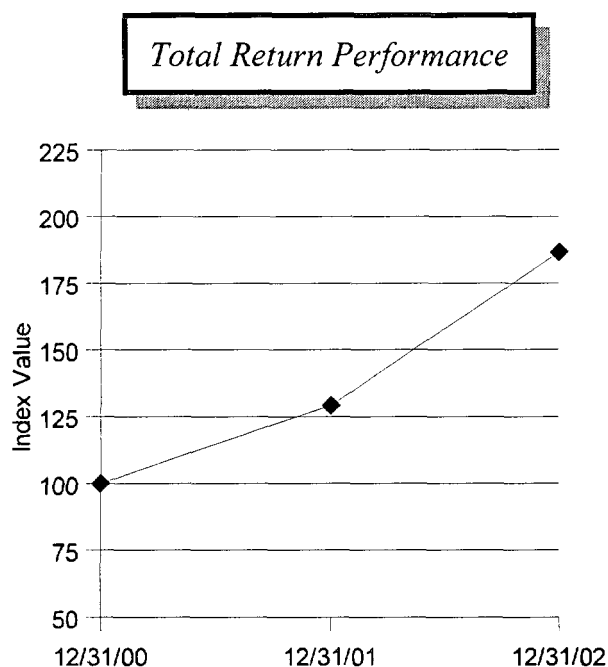
J. Gerald Bazewicz
J. Gerald Bazewicz, President

Your Investment In First Keystone Corporation

Impressive Performance. During 2002, your investment in First Keystone Corporation (FKYS) continued to perform exceptionally well. The market price increased from \$18.69 as of December 31, 2001, to \$26.00 as of December 31, 2002. Together with our cash dividend payout, this resulted in a total return of 44.3% for 2002.

	<u>2002</u>	<u>2001</u>
Market price at beginning of the year	\$18.69	\$15.12
Market price at the end of the year	26.00	18.69
Cash dividends	.85	.77
<i>Return</i>	44.3%*	29.2%*

* Assumes the reinvestment of cash dividends into additional shares



The chart illustrates how \$100.00 invested in First Keystone Corporation common stock on 12/31/2000 has grown to \$186.54 as of 12/31/2002.

<u>Index</u>	<u>12/31/00</u>	<u>12/31/01</u>	<u>12/31/02</u>
First Keystone Corporation (FKYS)	100.00	129.24	186.54

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2002 and 2001

	2002	2001
ASSETS		
Cash and due from banks	\$ 7,396,004	\$ 6,500,362
Interest-bearing deposits in other banks	60,060	49,975
Investment securities Available-for-Sale	209,822,667	178,098,522
Investment securities Held-to-Maturity (estimated fair value 2002 - \$5,925,209; 2001 - \$5,986,176)	5,932,331	6,008,710
Loans, net of unearned income	201,517,492	198,224,288
Allowance for loan losses	(3,174,616)	(2,922,405)
Net loans	<u>\$198,342,876</u>	<u>\$195,301,883</u>
Premises and equipment, net	3,429,507	3,275,266
Accrued interest receivable	3,068,952	2,993,904
Cash surrender value of bank owned life insurance	10,102,069	-
Other assets	<u>1,371,154</u>	<u>1,243,280</u>
TOTAL ASSETS	<u>\$439,525,620</u>	<u>\$393,471,902</u>
LIABILITIES		
Deposits:		
Non-interest bearing	\$ 30,056,766	\$ 25,576,032
Interest bearing	<u>300,688,512</u>	<u>269,104,791</u>
Total Deposits	330,745,278	\$294,680,823
Short-term borrowings	9,067,145	11,566,364
Long-term borrowings	45,750,000	45,250,000
Accrued interest and other expenses	1,648,499	2,082,824
Other liabilities	<u>3,218,657</u>	<u>196,014</u>
TOTAL LIABILITIES	<u>\$390,429,579</u>	<u>\$353,776,025</u>
STOCKHOLDERS' EQUITY		
Preferred stock, par value \$10.00 per share; authorized and unissued 500,000 shares	\$ -	\$ -
Common stock, par value \$2.00 per share; authorized 10,000,000 shares; issued 3,075,180 shares in 2002 and 2,933,727 shares in 2001	6,150,360	5,867,454
Surplus	12,583,626	9,761,066
Retained earnings	27,394,962	26,449,437
Accumulated other comprehensive income	6,543,981	714,601
Treasury stock, at cost, 119,181 shares in 2002 and 100,000 shares in 2001	<u>(3,576,888)</u>	<u>(3,096,681)</u>
TOTAL STOCKHOLDERS' EQUITY	<u>\$ 49,096,041</u>	<u>\$ 39,695,877</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$439,525,620</u>	<u>\$393,471,902</u>

The accompanying notes are an integral part of these consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 and 2000

	2002	2001	2000
INTEREST INCOME			
Interest and fees on loans	\$14,963,423	\$15,830,542	\$15,891,357
Interest and dividends on investment securities:			
Taxable	7,891,547	7,871,300	6,044,612
Tax-exempt	2,607,574	2,492,147	3,185,612
Dividends	320,976	414,099	521,415
Deposits in banks	<u>78,211</u>	<u>228,392</u>	<u>7,404</u>
Total interest income	<u>\$25,861,731</u>	<u>\$26,836,480</u>	<u>\$25,650,400</u>
INTEREST EXPENSE			
Deposits	\$ 8,116,618	\$11,690,814	\$10,972,391
Short-term borrowings	146,613	346,727	1,317,936
Long-term borrowings	<u>3,078,389</u>	<u>2,427,519</u>	<u>1,705,032</u>
Total interest expense	<u>\$11,341,620</u>	<u>\$14,465,060</u>	<u>\$13,995,359</u>
Net interest income	\$14,520,111	\$12,371,420	\$11,655,041
Provision for loan losses	<u>550,000</u>	<u>610,000</u>	<u>425,000</u>
Net interest income after provision for loan losses	<u>\$13,970,111</u>	<u>\$11,761,420</u>	<u>\$11,230,041</u>
NON-INTEREST INCOME			
Trust Department	\$ 509,842	\$ 554,606	\$ 570,631
Service charges and fees	1,372,935	1,232,368	1,093,057
Gain on sale of loans	228,194	184,013	58,093
Investment securities gains (losses) - net	28,647	278,474	113,001
Other	<u>145,161</u>	<u>96,344</u>	<u>40,272</u>
Total non-interest income	<u>\$ 2,284,779</u>	<u>\$ 2,345,805</u>	<u>\$ 1,875,054</u>
NON-INTEREST EXPENSE			
Salaries and employee benefits	\$ 4,222,354	\$ 3,895,588	\$ 3,761,797
Occupancy, net	485,578	447,294	431,223
Furniture and equipment	616,004	567,644	569,590
State Shares Tax	366,523	333,710	308,747
Other	<u>2,120,679</u>	<u>1,936,143</u>	<u>1,715,234</u>
Total non-interest expense	<u>\$ 7,811,138</u>	<u>\$ 7,180,379</u>	<u>\$ 6,786,591</u>
Income before income taxes	\$ 8,443,752	\$ 6,926,846	\$ 6,318,504
Income tax expense	<u>1,856,603</u>	<u>1,493,445</u>	<u>1,110,397</u>
NET INCOME	<u>\$ 6,587,149</u>	<u>\$ 5,433,401</u>	<u>\$ 5,208,107</u>
PER SHARE DATA			
Net income per share:*			
Basic	\$ 2.22	\$ 1.83	\$ 1.75
Diluted	\$ 2.21	\$ 1.83	\$ 1.75
Cash dividends per share*	\$.85	\$.77	\$.73

*Adjusted for 5% stock dividend declared June 25, 2002, to shareholders of record July 16, 2002, payable August 6, 2002.

The accompanying notes are an integral part of these consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 and 2000

	Common Stock	Surplus	Comprehensive Income (Loss)	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance At December 31, 1999	\$5,867,454	\$ 9,761,066		\$20,285,218	\$(3,459,538)	\$(3,096,681)	\$29,357,519
Comprehensive Income (Loss):							
Net income			\$ 5,208,107	5,208,107			5,208,107
Change in net unrealized gain (loss) on investment securities available-for- sale, net of reclassification adjustment and tax effects			<u>4,273,981</u>		4,273,981		4,273,981
Total comprehensive income (loss)			<u>\$ 9,482,088</u>				
Cash dividends - \$.73 per share				(2,181,970)			(2,181,970)
Balance At December 31, 2000	\$5,867,454	\$ 9,761,066		\$23,311,355	\$ 814,443	\$(3,096,681)	\$36,657,637
Comprehensive Income (Loss):							
Net income			\$ 5,433,401	5,433,401			5,433,401
Change in net unrealized gain (loss) on investment securities available-for- sale, net of reclassification adjustment and tax effects			<u>(99,842)</u>		(99,842)		(99,842)
Total comprehensive income (loss)			<u>\$ 5,333,559</u>				
Cash dividends - \$.77 per share				(2,295,319)			(2,295,319)
Balance At December 31, 2001	\$5,867,454	\$ 9,761,066		\$26,449,437	\$ 714,601	\$(3,096,681)	\$39,695,877
Comprehensive Income (Loss):							
Net income			\$ 6,587,149	6,587,149			6,587,149
Change in net unrealized gain (loss) on investment securities available-for- sale, net of reclassification adjustment and tax effects			<u>5,829,380</u>		5,829,380		5,829,380
Total comprehensive income (loss)			<u>\$12,416,529</u>				
5% stock dividend	282,906	2,829,060		(3,111,966)			-
Dividends paid in lieu of fractional shares				(4,725)			(4,725)
Cash dividends - \$.85 per share				(2,524,933)			(2,524,933)
Purchase of 20,181 shares of treasury stock						(503,707)	(503,707)
Sale of 1,000 shares of treasury stock for employee stock option plan		(6,500)				23,500	17,000
Balance At December 31, 2002	\$6,150,360	\$12,583,626		\$27,394,962	\$ 6,543,981	\$(3,576,888)	\$49,096,041

The accompanying notes are an integral part of these consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 and 2000

	2002	2001	2000
OPERATING ACTIVITIES			
Net income	\$ 6,587,149	\$ 5,433,401	\$ 5,208,107
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	550,000	610,000	425,000
Depreciation and amortization	446,313	384,925	406,244
Premium amortization on investment securities	556,617	325,036	99,905
Discount accretion on investment securities	(567,358)	(950,450)	(1,041,070)
Deferred income tax benefit	(79,854)	(105,349)	(12,487)
Gain on sale of mortgage loans	(228,194)	(184,013)	(58,093)
Proceeds from sale of mortgage loans originated for resale	8,322,360	9,373,829	3,912,715
Originations of mortgage loans held for resale	(10,522,610)	(6,034,088)	(3,030,719)
Gain on sales of investment securities	(28,647)	(278,474)	(113,001)
Loss on sale of foreclosed real estate	5,000	54,808	35,549
Increase in accrued interest receivable	(75,048)	(502,812)	(252,258)
Increase in cash surrender value of bank owned life insurance	(102,069)	-	-
Increase in other assets - net	(304,251)	(422,755)	(85,528)
Increase (decrease) in accrued interest and other expenses	(434,325)	(148,448)	399,407
Increase in other liabilities - net	127,932	111,637	32,485
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 4,253,015	\$ 7,667,247	\$ 5,926,256
INVESTING ACTIVITIES			
Proceeds from sales of investment securities Available-for-Sale	\$ 46,732,078	\$ 34,689,482	\$ 42,234,478
Proceeds from maturities and redemptions of investment securities Available-for-Sale	27,014,603	45,400,938	6,859,854
Purchases of investment securities Available-for-Sale	(96,557,845)	(108,563,617)	(64,194,871)
Proceeds from maturities and redemption of investment securities Held-to-Maturity	1,035,535	1,580,584	1,191,510
Purchases of investment securities Held-to-Maturity	(982,690)	-	-
Net increase in loans	(1,192,549)	(11,688,658)	(6,668,862)
Purchases of premises and equipment	(545,291)	(89,699)	(95,726)
Proceeds from sale of foreclosed real estate	100,000	473,901	118,000
Purchase of bank owned life insurance policies	(10,000,000)	-	-
NET CASH USED IN INVESTING ACTIVITIES	\$ (34,396,159)	\$ (38,197,069)	\$ (20,555,617)
FINANCING ACTIVITIES			
Net increase in deposits	\$ 36,064,455	\$ 23,207,813	\$ 26,792,826
Net increase (decrease) in short-term borrowings	(2,499,219)	3,006,709	(23,034,672)
Proceeds from long-term borrowings	8,000,000	11,000,000	32,500,000
Repayment of long-term borrowings	(7,500,000)	(7,000,000)	(17,250,000)
Dividends paid in lieu of fractional shares	(4,725)	-	-
Acquisition of Treasury Stock	(503,707)	-	-
Cash dividends paid	(2,524,933)	(2,295,319)	(2,181,970)
Proceeds from sale of treasury stock for employee stock option plan	17,000	-	-
NET CASH PROVIDED BY FINANCING ACTIVITIES	\$ 31,048,871	\$ 27,919,203	\$ 16,826,184
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ 905,727	\$ (2,610,619)	\$ 2,196,823
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	6,550,337	9,160,956	6,964,133
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 7,456,064	\$ 6,550,337	\$ 9,160,956

The accompanying notes are an integral part of these consolidated financial statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

Notes to Consolidated Financial Statements for Years Ended December 31, 2002, 2001 and 2000

Note 1 Summary of Significant Accounting Policies

The accounting policies of First Keystone Corporation and Subsidiary (the "Corporation") are in accordance with accounting principles generally accepted in the United States of America and conform to common practices within the banking industry. The more significant policies follow:

Principles of Consolidation

The consolidated financial statements include the accounts of First Keystone Corporation and its wholly-owned Subsidiary, The First National Bank of Berwick (the "Bank"). All significant inter-company balances and transactions have been eliminated in consolidation.

Nature of Operations

The Corporation, headquartered in Berwick, Pennsylvania, provides a full range of banking, trust and related services through its wholly owned Bank subsidiary and is subject to competition from other financial institutions in connection with these services. The Bank serves a customer base which includes individuals, businesses, public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has ten full service offices and 14 ATMs located in Columbia, Luzerne and Montour Counties. The Corporation and its subsidiary must also adhere to certain federal banking laws and regulations and are subject to periodic examinations made by various federal agencies.

Segment Reporting

The Corporation's banking subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs personal, corporate, pension and fiduciary services through its Trust Department.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Corporation. Currently, management measures the performance and allocates the resources of First Keystone Corporation as a single segment.

Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could differ from those estimates.

Investment Securities

The Corporation classifies its investment securities as either "Held-to-Maturity" or "Available-for-Sale" at the time of purchase. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Investment securities Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity and equity securities are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as other comprehensive income (loss) in the Consolidated Statement of Stockholders' Equity. Management's decision to sell Available-for-Sale securities is based on changes in economic conditions controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends is included in interest income from investments. Realized gains and losses are included in net investment securities gains. The cost of investment securities sold, redeemed or matured is based on the specific identification method.

Loans

Loans are stated at their outstanding unpaid principal balances, net of deferred fees or costs, unearned income and the allowance for loan losses. Interest on installment loans is recognized as income over the term of each loan, generally, by the "actuarial method". Interest on all other loans is primarily recognized based upon the principal amount outstanding on an actual day basis. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the interest method over the contractual life of the related loans as an interest yield adjustment.

Mortgage loans held for resale are carried at the lower of cost or market on an aggregate basis. These loans are sold without recourse to the Corporation.

Past-Due Loans — Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 15 days or more. Delinquent notices are generated automatically when a loan is 15 days past-due, depending on the type of loan. Collection efforts continue on loans past-due beyond 60 days that have not been satisfied, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

Non-Accrual Loans — Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Certain non-accrual loans may continue to perform, that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny and if performance continues, interest income may be recorded on a cash basis based on management's judgement as to collectibility of principal.

Allowance for Loan Losses — The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

A principal factor in estimating the allowance for loan losses is the measurement of impaired loans. A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the effective interest rate of the loan or the fair value of the collateral for certain collateral dependent loans.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management's periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

Derivatives

The Bank has outstanding loan commitments that relate to the origination of mortgage loans that will be held for resale. Pursuant to Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities" as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" and the guidance contained within the Derivatives Implementation Group Statement 133 Implementation Issue No. C 13, the Bank has accounted for such loan commitments as derivative instruments. The effective date of the implementation guidance is the first day of the first fiscal quarter beginning after April 10, 2002. The outstanding loan commitments in this category did not give rise to any losses for the year ended December 31, 2002, as the fair market value of each outstanding loan commitment exceeded the Bank's cost basis in each outstanding loan commitment.

Premises and Equipment

Premises, improvements and equipment are stated at cost less accumulated depreciation computed principally on the straight-line method over the estimated useful lives of the assets. Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate that the carrying value may not be recovered. Maintenance and minor repairs are charged to operations as incurred. The cost and accumulated depreciation of the premises and equipment retired or sold are eliminated from the property accounts at the time of retirement or sale, and the resulting gain or loss is reflected in current operations.

Mortgage Servicing Rights

The Corporation originates and sells real estate loans to investors in the secondary mortgage market. After the sale, the Corporation retains the right to service these loans. When originated mortgage loans are sold and servicing is retained, a servicing asset is capitalized based on relative fair value at the date of sale. Servicing assets are amortized as an offset to other fees in proportion to, and over the period of, estimated net servicing income. The unamortized cost is included in other assets in the accompanying consolidated balance sheet. The servicing rights are periodically evaluated for impairment based on their relative fair value.

Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value on the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less cost to sell and is included in other assets. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in other non-interest income and expense.

Bank Owned Life Insurance

The Corporation invests in Bank Owned Life Insurance (BOLI) with split dollar life provisions. Purchase of BOLI provides life insurance coverage on certain employees with the Corporation being owner and beneficiary of the policies.

Investment in Real Estate Venture

In October of 2000, the Bank became a limited partner in a real estate venture that owns and operates an affordable residential low-income housing apartment building for elderly residents. The investment is accounted for under the effective yield method under the Emerging Issues Task Force (EITF) 94-1 "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects". Under the effective yield method, the Bank recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that the tax credits are allocated to the Bank. Under this method, the tax credit allocated, net of any amortization of the investment in the limited partnership, is recognized in the consolidated statements of income as a component of income tax expense. The amount of tax credits allocated to the Bank were \$80,865 and \$26,674 in 2002 and 2001, respectively, and the amortization of the limited partnership investment was \$55,263 and \$18,081 in 2002 and 2001, respectively. The carrying value of the investment as of December 31, 2002, and 2001, was \$562,021 and \$617,284, respectively, and is carried in Other Assets in the accompanying consolidated balance sheet.

Income Taxes

The provision for income taxes is based on the results of operations, adjusted primarily for tax-exempt income. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. Deferred tax assets and liabilities are determined based on the differences between the consolidated financial statement and income tax bases of assets and liabilities measured by using the enacted tax rates and laws expected to be in effect when the timing differences are expected to reverse. Deferred tax expense or benefit is based on the difference between deferred tax asset or liability from period to period.

Stock Based Compensation

The Corporation accounts for stock options and shares issued under the Stock Option Incentive Plan in accordance with Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees". Under this method no compensation expense is recognized for stock options when the exercise price equals the fair value of the options at the grant date. Under provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock Based Compensation", the fair value of a stock option is required to be recognized as compensation expense over the service period (generally the vesting period). As permitted under SFAS No. 123 the Corporation has elected to continue to account for its stock option plan in accordance with APB No. 25. Additionally, as required, the notes to the consolidated financial statements disclose the proforma impact to net income and earnings per share that would occur if compensation expense had been recognized under SFAS No. 123.

Per Share Data

Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings Per Share", requires dual presentation of basic and fully diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding at the end of each period. Diluted earnings per share is calculated by increasing the denominator for the assumed conversion of all potentially dilutive securities. The Corporation's dilutive securities are limited to stock options which had no effect on earnings per share since the market price per share historically has not been greater than the lowest stock option exercise price for years prior to December 31, 2002.

Per share data has been adjusted retroactively for stock splits and stock dividends.

The reconciliation of the numerators and denominators of the basis and diluted earnings per share follows:

	<u>Year Ended December 31, 2002</u>		
	<u>Net Income</u>	<u>Weighted Average</u> <u>Number of Shares</u>	<u>Per Share</u>
	<u>Numerators</u>	<u>Denominators</u>	<u>Amount</u>
Net income	<u>\$6,587,149</u>		
Basic earnings per share:			
Income available to common stockholders	\$6,587,149	2,972,210	\$2.22
Effect of dilutive securities:			
Stock options		<u>2,541</u>	
Diluted earnings per share:			
Income available to common stockholders	\$6,587,149	2,974,751	\$2.21

	<u>Year Ended December 31, 2001</u>		
	<u>Net Income</u>	<u>Weighted Average</u> <u>Number of Shares</u>	<u>Per Share</u>
	<u>Numerators</u>	<u>Denominators</u>	<u>Amount</u>
Net income	<u>\$5,433,401</u>		
Basic earnings per share:			
Income available to common stockholders	\$5,433,401	2,975,180	\$1.83
Effect of dilutive securities:			
Stock options		<u>0</u>	
Diluted earnings per share:			
Income available to common stockholders	\$5,433,401	2,975,180	\$1.83

	<u>Year Ended December 31, 2000</u>		
	<u>Net Income</u>	<u>Weighted Average</u> <u>Number of Shares</u>	<u>Per Share</u>
	<u>Numerators</u>	<u>Denominators</u>	<u>Amount</u>
Net income	<u>\$5,208,107</u>		
Basic earnings per share:			
Income available to common stockholders	\$5,208,107	2,975,180	\$1.75
Effect of dilutive securities:			
Stock options		<u>0</u>	
Diluted earnings per share:			
Income available to common stockholders	\$5,208,107	2,975,180	\$1.75

Cash Flow Information

For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and due from other banks and interest bearing deposits in other banks. The Corporation considers cash classified as interest bearing deposits with other banks as a cash equivalent since they are represented by cash accounts essentially on a demand basis.

Interest paid on deposits and other borrowings was \$11,456,466, \$14,904,607 and \$13,691,639 in 2002, 2001 and 2000, respectively. Cash payments for income taxes were \$2,263,801, \$1,442,884 and \$1,024,517 for 2002, 2001 and 2000, respectively. The Corporation transferred loans to foreclosed assets held for sale in the amounts of \$30,000, \$590,375 and \$81,982 in 2002, 2001 and 2000, respectively.

Trust Assets and Income

Property held by the Corporation in a fiduciary or agency capacity for its customers is not included in the accompanying consolidated financial statements since such items are not assets of the Corporation. Trust Department income is generally recognized on a cash basis and is not materially different than if it were reported on an accrual basis.

Recent Accounting Pronouncements

Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," is generally effective for all business combinations initiated after June 30, 2001, and replaces APB Opinion No. 16, "Business Combinations" and SFAS No. 38 "Accounting for Preacquisition Contingencies of Purchased Enterprises". All business combinations under this statement are to be accounted for under the purchase method of accounting as the pooling-of-interest method is prohibited. The standard does not have any impact on the Corporation's consolidated financial condition or results of operations.

Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets" is generally effective for fiscal years beginning after December 31, 2001, and addresses the financial accounting and reporting for acquired goodwill and other intangible assets and replaces APB Opinion No. 17, "Intangible Assets". The statement addresses how intangible assets that are acquired individually or with a group or other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. Goodwill and other intangible assets with an indefinite useful life should not be amortized but should be tested for impairment at least annually. Intangibles that are separable from goodwill and that have a determinable useful life should be amortized over the determinable useful life. The standard does not have any impact on the Corporation's consolidated financial condition or results of operations.

Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations" is generally effective for financial statements for fiscal years beginning after June 15, 2002. The statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction development and (or) the normal operation of a long-lived asset. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. This standard does not have any impact on the Corporation's consolidated financial condition or results of operations.

Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets" is generally effective for financial statements issued for fiscal years beginning after December 15, 2001, and for interim periods within those fiscal years. The statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The statement replaces FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", for the disposal of a "segment of a business" (as previously defined in that Opinion). The statement also amends ARB No. 51, "Consolidated Financial Statements", to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. This standard does not have any impact on the Corporation's consolidated financial conditions or results of operations.

Statement of Financial Accounting Standards (SFAS) No. 145, "Recession of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections" is generally effective for financial statements issued on or after May 15, 2002. The statement rescinds FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt", and an amendment of that statement, FASB Statement No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements". The statement amends FASB Statement No. 13, "Accounting for Leases", to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. This standard does not have any impact on the Corporation's consolidated financial condition or results of operations.

Advertising Costs

It is the Corporation's policy to expense advertising costs in the period in which they are incurred. Advertising expense for the years ended December 31, 2002, 2001 and 2000, was approximately \$218,977, \$141,258 and \$166,047, respectively.

Reporting Format

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2002 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

Note 2 Restricted Cash Balances

The Bank is required to maintain certain average reserve balances as established by the Federal Reserve Bank. The amount of those reserve balances for the reserve computation period which included December 31, 2002, was \$819,000, which was satisfied through the restriction of vault cash. In addition, the Bank maintains a clearing balance at the Federal Reserve Bank to offset specific charges for services. At December 31, 2002, the amount of this balance was \$700,000.

Note 3 Investment Securities

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at December 31, 2002 and 2001:

	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>December 31, 2002:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 71,510,863	\$ 1,677,919	\$ 6,212	\$ 73,182,570
Other	4,520,687	102,780	-	4,623,467
Obligations of state and political subdivisions	79,569,388	5,276,818	37,445	84,808,761
Corporate securities	36,191,874	2,254,868	1,093	38,445,649
Marketable equity securities	4,580,397	823,581	93,858	5,310,120
Restricted equity securities	3,452,100	-	-	3,452,100
Total	<u>\$199,825,309</u>	<u>\$10,135,966</u>	<u>\$ 138,608</u>	<u>\$209,822,667</u>

	Held-to-Maturity Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>December 31, 2002:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 4,272,615	\$ 2,143	\$ 38,385	\$ 4,236,373
Obligations of state and political subdivisions	1,659,716	29,120	-	1,688,836
Total	<u>\$ 5,932,331</u>	<u>\$ 31,263</u>	<u>\$ 38,385</u>	<u>\$ 5,925,209</u>

	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>December 31, 2001:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 47,935,402	\$ 544,911	\$ 189,396	\$ 48,290,917
Other	7,002,995	37,059	64,284	6,975,770
Obligations of state and political subdivisions	74,592,346	1,422,707	1,830,920	74,184,133
Corporate securities	40,771,712	885,054	322,541	41,334,225
Marketable equity securities	3,621,566	694,521	29,810	4,286,277
Restricted equity securities	3,027,200	-	-	3,027,200
Total	<u>\$176,951,221</u>	<u>\$3,584,252</u>	<u>\$2,436,951</u>	<u>\$178,098,522</u>

	Held-to-Maturity Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<i>December 31, 2001:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 5,331,965	\$ 8,120	\$ 34,395	\$ 5,305,690
Obligations of state and political subdivisions	676,745	3,741	-	680,486
Total	<u>\$ 6,008,710</u>	<u>\$ 11,861</u>	<u>\$ 34,395</u>	<u>\$ 5,986,176</u>

Securities Available-for-Sale with an aggregate fair value of \$59,575,229 in 2002 and \$65,361,585 in 2001; and securities Held-to-Maturity with an aggregate unamortized cost of \$5,942,622 in 2002 and \$6,008,710 in 2001, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of \$37,693,072 in 2002 and \$40,484,090 in 2001 as required by law.

The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at December 31, 2002. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2002				
	U.S. Government Agency & Corporation <u>Obligations</u> ¹	Obligations of State & Political <u>Subdivisions</u> ²	Marketable Equity <u>Securities</u> ³	Restricted Equity <u>Securities</u> ³	Corporate <u>Securities</u>
Available-For-Sale:					
Within 1 Year:					
Amortized cost	\$ -	\$ -	\$ -	\$ -	\$ -
Estimated fair value	-	-	-	-	-
Weighted average yield	-	-	-	-	-
1 - 5 Years:					
Amortized cost	11,918,642	1,002,101	-	-	28,249,885
Estimated fair value	12,016,787	1,078,510	-	-	29,686,937
Weighted average yield	3.91%	5.10%	-	-	6.01%
5 - 10 Years:					
Amortized cost	33,903,116	7,571,074	-	-	6,830,569
Estimated fair value	34,436,410	8,099,046	-	-	7,551,612
Weighted average yield	4.47%	5.98%	-	-	6.56%
After 10 Years:					
Amortized cost	30,209,792	70,996,213	4,580,397	3,452,100	1,111,420
Estimated fair value	31,352,840	75,631,205	5,310,120	3,452,100	1,207,100
Weighted average yield	<u>6.00%</u>	<u>7.33%</u>	<u>4.41%</u>	<u>3.63%</u>	<u>5.94%</u>
Total:					
Amortized cost	\$76,031,550	\$79,569,388	\$4,580,397	\$3,452,100	\$36,191,874
Estimated fair value	77,806,037	84,808,761	5,310,120	3,452,100	38,445,649
Weighted average yield	4.99%	7.18%	4.41%	3.63%	6.12%

¹Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

²Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

³Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

December 31, 2002

	U.S. Government Agency & Corporation <u>Obligations</u> ¹	Obligations of State & Political Subdivisions ²	Marketable Equity Securities ³	Restricted Equity Securities ³	Corporate Securities
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Held-To-Maturity:

Within 1 Year:

Amortized cost	\$ -	\$ -	\$ -	\$ -	\$ -
Estimated fair value	-	-	-	-	-
Weighted average yield	-	-	-	-	-

1 - 5 Years:

Amortized cost	-	-	-	-	-
Estimated fair value	-	-	-	-	-
Weighted average yield	-	-	-	-	-

5 - 10 Years:

Amortized cost	-	195,098	-	-	-
Estimated fair value	-	195,906	-	-	-
Weighted average yield	-	6.30%	-	-	-

After 10 Years:

Amortized cost	4,272,615	1,464,618	-	-	-
Estimated fair value	4,236,373	1,492,930	-	-	-
Weighted average yield	4.35%	7.06%	-	-	-

Total:

Amortized cost	\$4,272,615	\$1,659,716	\$ -	\$ -	\$ -
Estimated fair value	4,236,373	1,688,836	-	-	-
Weighted average yield	4.35%	6.97%	-	-	-

¹Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

²Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

³Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

Restricted equity securities consist of stock in the Federal Home Loan Bank of Pittsburgh (FHLB), Federal Reserve Bank (FRB) and Atlantic Central Bankers Bank (ACBB) and do not have a readily determinable fair value for purposes of SFAS No. 115, because their ownership is restricted and they can be sold back only to the FHLB, FRB, ACBB or to another member institution. Therefore, these securities are classified as restricted equity investment securities, carried at cost, and evaluated for impairment.

There were no aggregate investments with a single issuer (excluding the U.S. Government and its agencies) which exceeded ten percent of consolidated shareholders' equity at December 31, 2002. The quality rating of all obligations of state and political subdivisions are "A" or higher, as rated by Moody's or Standard and Poors. The only exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities. All of the state and political subdivision investments are actively traded in a liquid market.

Proceeds from sale of investments in Available-for-Sale debt and equity securities during 2002, 2001, and 2000 were \$46,732,078, \$34,689,482, and \$42,234,478, respectively. Gross gains realized on these sales were \$574,090, \$570,162, and \$642,360, respectively. Gross losses on these sales were \$545,443, \$291,688, and \$29,359, respectively.

Note 4 Loans

Major classifications of loans at December 31, 2002 and 2001 consisted of:

	<u>2002</u>	<u>2001</u>
Commercial, Financial, and Agricultural	\$ 23,638,919	\$ 24,062,354
Tax-exempt	4,393,344	7,958,051
Real estate mortgage - Held for sale	4,897,339	2,468,896
Real estate mortgage - Other	145,599,828	138,148,763
Consumer	<u>28,639,586</u>	<u>32,075,130</u>
Gross loans	\$207,169,016	\$204,713,194
Deduct (Add): Unearned discount	5,777,975	6,590,552
Net deferred loan fees and costs	<u>(126,451)</u>	<u>(101,646)</u>
Loans, net of unearned income	<u>\$201,517,492</u>	<u>\$198,224,288</u>

Changes in the allowance for loan losses for the years ended December 31, 2002, 2001 and 2000, were as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Balance, January 1	\$ 2,922,405	\$ 2,702,313	\$ 2,599,550
Provision charged to operations	550,000	610,000	425,000
Loans charged off	(402,112)	(458,242)	(349,387)
Recoveries	<u>104,323</u>	<u>68,334</u>	<u>27,150</u>
Balance, December 31	<u>\$ 3,174,616</u>	<u>\$ 2,922,405</u>	<u>\$ 2,702,313</u>

Non-accrual loans at December 31, 2002, 2001 and 2000 were \$457,565, \$1,101,736, and \$714,214, respectively. The gross interest that would have been recorded if these loans had been current in accordance with their original terms and the amounts actually recorded in income were as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gross interest due under terms	\$38,956	\$93,258	\$67,584
Amount included in income	<u>(19,179)</u>	<u>(72,382)</u>	<u>(30,345)</u>
Interest income not recognized	<u>\$19,777</u>	<u>\$20,876</u>	<u>\$37,239</u>

At December 31, 2002, 2001 and 2000 the recorded investment in loans that are considered to be impaired as defined by SFAS No. 114 was \$35,565, \$85,471 and \$61,192, respectively. No additional charge to operations was required to provide for the impaired loans since the total allowance for loan losses is estimated by management to be adequate to provide for the loan loss allowance required by SFAS No. 114 along with any other potential losses. The average recorded investment in impaired loans during the year ended December 31, 2002, 2001 and 2000 was approximately \$109,201, \$124,000 and \$77,014, respectively.

There were no loans past-due 90 days or more and still accruing interest at December 31, 2002, as presented in accordance with ACCPA Statement of Position 01-6, "Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others", effective for fiscal years beginning after December 15, 2001.

At December 31, 2002, there were no significant commitments to lend additional funds with respect to non-accrual and restructured loans.

Note 5 Mortgage Servicing Rights

The mortgage loans serviced for others are not included in the accompanying Consolidated Balance Sheets. The unpaid principal balances of mortgage loans serviced for others was \$23,141,951 and \$19,674,674 at December 31, 2002 and 2001, respectively.

Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in demand deposits, were approximately \$20,250 and \$13,518 at December 31, 2002 and 2001, respectively.

Changes in the balances of servicing assets for the years ended December 31, 2002, 2001 and 2000 were as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Balance at January 1	\$187,435	\$124,340	\$104,999
Servicing asset additions	74,704	88,996	32,467
Amortization	<u>(43,242)</u>	<u>(25,901)</u>	<u>(13,126)</u>
Balance at December 31	<u>\$218,897</u>	<u>\$187,435</u>	<u>\$124,340</u>

A valuation allowance on mortgage servicing assets has not been required. Mortgage servicing rights in the Consolidated Balance Sheet are included in other assets at December 31, 2002 and 2001.

Note 6 Premises and Equipment

A summary of premises and equipment at December 31, 2002 and 2001 follows:

	<u>2002</u>	<u>2001</u>
Land	\$ 876,526	\$ 876,526
Buildings	2,731,999	2,696,145
Leasehold improvements	289,759	127,059
Equipment	<u>4,356,353</u>	<u>4,073,758</u>
	8,254,637	7,773,488
Less: Accumulated depreciation	<u>4,825,130</u>	<u>4,498,222</u>
Total	<u>\$3,429,507</u>	<u>\$3,275,266</u>

Depreciation amounted to \$391,050 for 2002, \$384,925 for 2001, and \$406,244 for 2000.

Note 7 Deposits

Major classifications of deposits at December 31, 2002 and 2001 consisted of:

	<u>2002</u>	<u>2001</u>
Demand - non-interest bearing	\$ 30,056,766	\$ 25,576,032
Demand - interest bearing	49,158,732	57,603,774
Savings	71,629,153	56,098,109
Time, \$100,000 and over	42,675,023	42,167,552
Other time	<u>137,225,604</u>	<u>113,235,356</u>
Total deposits	<u>\$330,745,278</u>	<u>\$294,680,823</u>

The following is a schedule reflecting classification and remaining maturities of time deposits of \$100,000 and over at December 31, 2002:

2003	\$32,806,970
2004	4,067,926
2005	2,054,893
2006	399,729
2007	<u>3,345,505</u>
	<u>\$42,675,023</u>

Interest expense related to time deposits of \$100,000 or more was \$1,374,694 in 2002, \$2,361,108 in 2001 and \$1,762,574 in 2000.

Note 8 Short-Term Borrowings

Federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank advances generally represent overnight or less than 30-day borrowings. U.S. Treasury tax and loan notes for collections made by the Bank are payable on demand. Short-term borrowings consisted of the following at December 31, 2002, and 2001:

	2002			
	Ending Balance	Average Balance	Maximum Month End Balance	Average Rate
Federal funds purchased and securities sold under agreements to repurchase	\$5,567,145	6,357,032	\$ 7,779,266	1.91%
Federal Home Loan Bank	1,500,000	819,477	4,150,000	1.96%
U.S. Treasury tax and loan notes	<u>2,000,000</u>	<u>559,068</u>	<u>2,004,036</u>	1.62%
Total	<u>\$9,067,145</u>	<u>\$7,735,577</u>	<u>\$13,933,302</u>	1.90%

	2001			
	Ending Balance	Average Balance	Maximum Month End Balance	Average Rate
Federal funds purchased and securities sold under agreements to repurchase	\$ 7,333,382	\$8,008,903	\$ 8,547,729	3.88%
Federal Home Loan Bank	3,550,000	458,869	3,550,000	3.32%
U.S. Treasury tax and loan notes	<u>682,982</u>	<u>559,038</u>	<u>1,856,438</u>	3.67%
Total	<u>\$11,566,364</u>	<u>\$9,026,810</u>	<u>\$13,954,167</u>	3.58%

Note 9 Long-Term Borrowings

Long-term borrowings are comprised of advances from the Federal Home Loan Bank (FHLB). Under terms of a blanket agreement, collateral for the loans are secured by certain qualifying assets of the Corporation's banking subsidiary which consist principally of first mortgage loans and certain investment securities.

A schedule of long-term borrowings by maturity as of December 31, 2002 and 2001 follows:

	2002	2001
Due 2002, 5.50%	\$ -	\$ 2,000,000
Due 2003, 6.79%	1,500,000	1,500,000
Due 2005, 6.49%	5,000,000	8,500,000
Due 2006, 3.12%	3,000,000	-
Due 2008, 5.48%	3,000,000	3,000,000
Due 2010, 5.45% to 6.76%	15,500,000	15,500,000
Due 2011, 4.23% to 5.03%	9,000,000	11,000,000
Due 2012, 4.77%	5,000,000	-
Due 2014, 5.41%	<u>3,750,000</u>	<u>3,750,000</u>
	<u>\$ 45,750,000</u>	<u>\$ 45,250,000</u>

Note 10 Income Taxes

The current and deferred components of the income tax provision (benefit) consisted of the following:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Federal			
Current	\$ 1,936,447	\$ 1,592,729	\$ 1,113,666
Deferred (benefit)	<u>(79,854)</u>	<u>(105,349)</u>	<u>(12,487)</u>
	<u>\$ 1,856,593</u>	<u>\$ 1,487,380</u>	<u>\$ 1,101,179</u>
State			
Current	<u>10</u>	<u>6,065</u>	<u>9,218</u>
Total provision for income taxes	<u>\$ 1,856,603</u>	<u>\$ 1,493,445</u>	<u>\$ 1,110,397</u>

The following is a reconciliation between the actual provision for federal income taxes and the amount of federal income taxes which would have been provided at the statutory rate of 34%:

	<u>2002</u>		<u>2001</u>		<u>2000</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
Provision at statutory rate	\$2,870,876	34.0%	\$2,355,128	34.0%	\$2,148,291	34.0%
Tax-exempt income	(994,782)	(11.8)	(952,900)	(13.8)	(1,169,262)	(18.5)
Non-deductible expenses	112,500	1.3	141,425	2.1	157,296	2.5
Tax credit from limited partnership						
Less amortization - net	(44,391)	(.5)	(14,741)	(.2)	-	-
Bank owned life insurance income - net	(32,734)	(.4)	1,952	-	2,053	-
Other, net	<u>(54,876)</u>	<u>(.6)</u>	<u>(43,484)</u>	<u>(.6)</u>	<u>(37,199)</u>	<u>(.6)</u>
Applicable federal income tax and rate	<u>\$1,856,593</u>	<u>22.0%</u>	<u>\$1,487,380</u>	<u>21.5%</u>	<u>\$1,101,179</u>	<u>17.4%</u>

Total federal income tax attributable to realized security gains and losses was \$9,740 in 2002, \$94,681 in 2001 and \$38,420 in 2000.

The deferred tax assets and liabilities resulting from temporary timing differences have been netted to reflect a net deferred tax asset (liability) included in other assets or other liabilities in these consolidated financial statements. The components of the net deferred tax asset (liability) at December 31, 2002, 2001 and 2000, are as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Deferred Tax Assets:			
Allowance for loan losses	\$ 932,466	\$ 846,714	\$ 771,882
Deferred compensation	177,098	141,022	105,142
Contributions	3,197	6,133	6,455
Non-accrual interest	5,229	3,209	-
Alternative minimum tax credits forward	-	-	13,798
Limited partnership	<u>9,095</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 1,127,085</u>	<u>\$ 997,078</u>	<u>\$ 897,277</u>
Deferred Tax Liabilities:			
Loan fees and costs	\$ (210,290)	\$ (209,338)	\$ (223,253)
Depreciation	(249,937)	(237,699)	(243,810)
Accretion	(98,809)	(62,260)	(52,763)
Mortgage servicing rights	(9,382)	(6,788)	(3,988)
Limited partnership	-	(2,181)	-
Unrealized investment securities gains	<u>(3,453,378)</u>	<u>(432,698)</u>	<u>(459,818)</u>
Total	<u>\$ (4,021,796)</u>	<u>\$ (950,964)</u>	<u>\$ (983,632)</u>
Net Deferred Tax Asset (Liability)	<u>\$ (2,894,711)</u>	<u>\$ 46,114</u>	<u>\$ (86,355)</u>

It is anticipated that all deferred tax assets are to be realized and accordingly, no valuation allowance has been provided.

Note 11 Employee Benefit Plans and Deferred Compensation Agreements

The Corporation maintains a 401K Plan which has a combined tax qualified savings feature and profit sharing feature for the benefit of its employees. Under the savings feature, the Corporation matches 100% of the employee contribution up to 3% of compensation which amounted to \$91,532, \$87,136, and \$81,262, in 2002, 2001 and 2000, respectively. Under the profit sharing feature, contributions, at the discretion of the Board of Directors are funded currently and amounted to \$350,894, \$212,421, and \$217,017 in 2002, 2001 and 2000, respectively.

The Bank also has non-qualified deferred compensation agreements with three of its officers. These agreements are essentially unsecured promises by the Bank to make monthly payments to the officers over a twenty year period. Payments begin based upon specific criteria — generally, when the officer retires. To account for the cost of payments yet to be made in the future, the Bank recognizes an accrued liability in years prior to when payments begin based on the present value of those future payments. The Bank's accrued liability for these deferred compensation agreements as of December 31, 2002 and 2001, was \$520,876 and \$414,773, respectively. The related expense for these plans amounted to \$110,334, \$105,533 and \$97,929 in 2002, 2001 and 2000, respectively.

Note 12 Lease Commitments and Contingencies

The Corporation's banking subsidiary currently leases five branch banking facilities, as well as the operations center adjoining the main bank office, under operating leases. Rent expense for the existing facilities for the years ended December 31, 2002, 2001 and 2000 was \$151,207, \$141,110 and \$137,876, respectively.

Minimum rental payments required under these operating leases are: 2003 - \$170,333, 2004 - \$111,492, 2005 - \$85,995, 2006 - \$51,000, 2007 - \$51,000 and thereafter \$238,000.

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the Consolidated Financial Statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position of the Corporation.

Note 13 Related Party Transactions

Certain directors and executive officers of First Keystone Corporation and its Subsidiary and companies in which they are principal owners (i.e., at least 10%) were indebted to the Corporation at December 31, 2002, 2001 and 2000. These loans were made on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated parties. The loans do not involve more than the normal risk of collectibility nor present other unfavorable features.

A summary of the activity on the related party loans, comprised of 8 directors and 5 executive officers and their related companies consists of the following:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Balance at January 1	\$ 3,005,435	\$ 1,455,475	\$ 1,708,323
Additions	1,482,405	3,050,795	493,879
Deductions	<u>(1,836,449)</u>	<u>(1,500,835)</u>	<u>(746,727)</u>
Balance at December 31	<u>\$ 2,651,391</u>	<u>\$ 3,005,435</u>	<u>\$ 1,455,475</u>

The above loans represent funds drawn and outstanding at the date of the accompanying consolidated financial statement. Commitments by the Bank to related parties on lines of credit and letters of credit for 2002, 2001 and 2000, presented an additional off-balance sheet risk to the extent of undisbursed funds in the amounts of \$2,308,737, \$4,334,140 and \$474,618, respectively, on the above loans.

Note 14 Regulatory Matters

Dividends are paid by the Corporation to shareholders which are mainly provided by dividends from the Bank. However, national banking laws place certain restrictions on the amount of cash dividends allowed to be paid by the Bank to the Corporation. Generally, the limitation provides that dividend payments may not exceed the Bank's current year's retained income plus retained net income for the preceding two years. Accordingly, in 2003, without prior regulatory approval, the Bank may declare dividends to the Corporation in the amount of \$6,778,084 plus additional amounts equal to the net income earned in 2003 for the period January 1, 2003, through the date of declaration, less any dividends which may have already been paid in 2003. Regulations also limit the amount of loans and advances from the Bank to the Corporation to 10% of consolidated net assets.

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — and possibly additional discretionary — actions by regulators that, if undertaken, could have a direct material effect on the Corporation's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Management believes, as of December 31, 2002 and 2001, that the Corporation and the Bank met all capital adequacy requirements to which they are subject.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier I Capital (as defined in the regulations) to Risk-Weighted Assets (as defined), and of Tier I Capital (as defined) to Average Assets (as defined).

As of December 31, 2002, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as Well Capitalized under the regulatory framework for prompt corrective action. To be categorized as Well Capitalized, the Bank must maintain minimum Total Risk-Based, Tier I Risk-Based and Tier I Leverage Ratios as set forth in the table. There are no conditions or events since the notification that management believes have changed the Bank's category.

(Amounts in thousands)	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2002:						
Total Capital						
(to Risk Weighted Assets)	\$44,211	16.52 %	\$21,409	8.00 %	\$26,762	10.00 %
Tier I Capital						
(to Risk Weighted Assets)	41,036	15.33 %	10,707	4.00 %	16,061	6.00 %
Tier I Capital						
(to Average Assets)	41,036	9.48 %	17,315	4.00 %	21,643	5.00 %
As of December 31, 2001:						
Total Capital						
(to Risk Weighted Assets)	\$40,270	15.54 %	\$20,731	8.00 %	\$25,914	10.00 %
Tier I Capital						
(to Risk Weighted Assets)	37,340	14.41 %	10,365	4.00 %	15,548	6.00 %
Tier I Capital						
(to Average Assets)	37,340	9.42 %	15,855	4.00 %	19,819	5.00 %

The Corporation's capital ratios are not materially different from those of the Bank.

Note 15 Financial Instruments with Off-Balance Sheet Risk and Concentrations of Credit Risk

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation may require collateral or other security to support financial instruments with off-balance sheet credit risk. The contract or notional amounts at December 31, 2002 and 2001 were as follows:

	<u>2002</u>	<u>2001</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 24,742,078	\$ 21,853,237
Standby letters of credit	\$ 3,630,215	\$ 2,588,989

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses that may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral to support standby letters of credit for which collateral is deemed necessary.

The Corporation grants commercial, agricultural, real estate mortgage and consumer loans to customers primarily in the counties of Columbia, Luzerne and Montour, Pennsylvania. The concentrations of credit by type of loan are set forth in Note 4, "Loans". It is management's opinion that the loan portfolio was well balanced and diversified at December 31, 2002, to the extent necessary to avoid any significant concentration of credit risk. However, its debtors ability to honor their contracts may be influenced by the region's economy.

Note 16 Comprehensive Income (Loss)

The components of other comprehensive income (loss) and related tax effects are as follows:

	<u>Years Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Unrealized holding gains (losses) on			
Available-for-Sale investment securities	\$ 8,878,707	\$ (405,435)	\$ 6,556,681
Less reclassification adjustment for gains realized in income	<u>28,647</u>	<u>278,474</u>	<u>113,001</u>
Net unrealized gains (losses)	\$ 8,850,060	\$ (126,961)	\$ 6,443,680
Tax effects	<u>(3,020,680)</u>	<u>27,119</u>	<u>(2,169,699)</u>
Net of tax amount	<u>\$ 5,829,380</u>	<u>\$ (99,842)</u>	<u>\$ 4,273,981</u>

Note 17 Stockholders' Equity

On June 25, 2002, the Board of Directors declared a 5% stock dividend payable August 6, 2002, to shareholders of record July 16, 2002. A total of 141,453 shares were issued as a result of this stock dividend, with a total value transferred from retained earnings of \$3,111,966, including cash in lieu of fractional shares.

The Corporation also offers to its shareholders a Dividend Reinvestment and Stock Purchase Plan. First Keystone Corporation is authorized to issue up to 100,000 shares of its common stock under the plan. The plan provides First Keystone shareholders a convenient and economical way to purchase additional shares of common stock by reinvesting dividends. A plan participant can elect full dividend reinvestment or partial dividend reinvestment provided at least 25 shares are enrolled in the plan. In addition, plan participants may make additional voluntary cash purchases of common stock under the plan of not less than \$100 per calendar quarter or more than \$2,500 in any calendar quarter.

Shares of First Keystone common stock are purchased for the plan either in the open market by an independent broker on behalf of the plan, directly from First Keystone as original issue shares, or through negotiated transactions. A combination of the previous methods could also occur.

Participation in this plan by shareholders began in 2001. Shares issued under this plan were (not including above referenced 5% stock dividend):

<u>Year</u>	<u>Number of Shares</u>
2001	3,260
2002	7,747

Note 18 Stock Options

On February 10, 1998, the Board of Directors adopted a stock option incentive plan and reserved 100,000 shares of common stock for issuance under the plan for certain employees of the Bank. Under the Plan, options are granted at fair market value and the time period during which any option granted may be exercised may not commence before six months or continue beyond the expiration of ten years after the option is awarded.

The Corporation accounts for its stock option plan in accordance with APB Opinion No. 25 "Accounting for Stock Issued to Employees". Under this method, no compensation expense is recognized for stock options when the exercise price equals the quoted market price at the date of grant. Had compensation cost for the plan been determined based on the fair value of the options at the grant date consistent with the method of SFAS No. 123 "Accounting for Stock-Based Compensation" the Corporation's consolidated net income and earnings per share would have been as follows:

		<u>2002</u>	<u>2001</u>	<u>2000</u>
Net income	As reported	\$ 6,587,149	\$ 5,433,401	\$ 5,208,107
	Pro forma	6,559,611	5,411,183	5,146,004
Basic Earnings Per Share	As reported	\$ 2.22	\$ 1.83	\$ 1.75
	Pro forma	2.21	1.83	1.75
Diluted Earnings Per Share	As reported	\$ 2.21	\$ 1.83	\$ 1.75
	Pro forma	2.20	1.83	1.75

The stock options were not required to be included in the computation of diluted earnings per share because the stock option's exercise price was greater than the average market price of the common shares for years prior to December 31, 2002.

The fair value of each option grant is estimated on the date of grant using the Binomial Option Pricing Model derived from the Black-Scholes Option Pricing Model with the following weighed-average assumptions used for options granted in 2002 and 2000, respectively (no options were granted in 2001): dividend yield of 3.58% and 3.80%; expected volatility of 28.00% and 32.17%; risk-free interest rate of 3.69% and 5.93%; and an expected life of 10 years and 8 years.

Information about stock options outstanding at December 31, 2002, is summarized as follows:

	<u>2002</u>		<u>2001</u>		<u>2000</u>	
	Stock	Weighted Average Exercise Price	Stock	Weighted Average Exercise Price	Stock	Weighted Average Exercise Price
	<u>Options</u>	<u>Price</u>	<u>Options</u>	<u>Price</u>	<u>Options</u>	<u>Price</u>
Balance at January 1	34,750	\$25.23	34,750	\$25.23	23,000	\$29.72
Granted	12,750	23.75	-	-	12,250	17.00
Granted due to stock dividend	1,568	24.00	-	-	-	-
Exercised	(1,000)	17.00	-	-	-	-
Forfeited	(2,000)	29.88	-	-	(500)	29.88
Balance at December 31	<u>46,068</u>	<u>\$23.93</u>	<u>34,750</u>	<u>\$25.23</u>	<u>34,750</u>	<u>\$25.23</u>
Exercisable at December 31	<u>33,318</u>	<u>\$24.00</u>	<u>34,750</u>	<u>\$25.23</u>	<u>22,500</u>	<u>\$29.71</u>
Weighted average fair value of options granted during the year		<u>\$ 6.55</u>		<u>\$ -</u>		<u>\$ 5.50</u>

Under the terms of the stock option incentive plan, the stock options including amendments as to price and terms were adjusted for the stock dividend in 2002. See Note 17.

Exercise prices of options outstanding as of December 31, 2002, ranged from \$16.19 to \$31.90 per share. The weighted average remaining contracted life is approximately 6 years.

The following table summarizes information concerning the 1998 Employee Stock Option Plan at December 31, 2002.

Year	Options Outstanding			Options Exercisable	
	Number Outstanding*	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
1998	10,232	5.75	\$31.90	10,232	31.90
1999	11,281	6.75	25.00	11,281	25.00
2000	11,805	7.75	16.19	11,805	16.19
2002	12,750	9.75	23.75	-	-
	46,068	7.61	\$23.93	33,318	\$24.00

*As adjusted for stock dividend noted above.

Note 19 Fair Values of Financial Instruments

Statement of Financial Accounting Standards (SFAS) No. 107, "Disclosures about Fair Value of Financial Instruments", requires disclosure of fair value information about financial instruments, whether or not required to be recognized in the consolidated balance sheet, for which it is practicable to estimate such fair value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. These techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Fair value estimates derived through these techniques cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation.

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments:

Cash and Due From Banks, Short-Term Investments, Accrued Interest Receivable and Accrued Interest Payable

The fair values are equal to the current carrying values.

Investment Securities

Fair values have been individually determined based on currently quoted market prices. If a quoted market price not available, fair value is estimated using quoted market prices for similar securities.

Loans

Fair values are estimated for categories of loans with similar financial characteristics. Loans were segregated by type such as commercial, tax-exempt, real estate mortgages and consumer. For estimation purposes each loan category was further segmented into fixed and adjustable rate interest terms and also into performing and non-performing classifications.

The fair value of each category of performing loans is calculated by discounting future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Fair value for non-performing loans is based on management's estimate of future cash flows discounted using a rate commensurate with the risk associated with the estimated future cash flows. The assumptions used by management are judgmentally determined using specific borrower information.

Deposits

Under SFAS No. 107, the fair value of deposits with no stated maturity, such as Demand Deposits, Savings Accounts and Money Market Accounts is equal to the amount payable on demand at December 31, 2002, and 2001.

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-Term and Long-Term Borrowings

The fair values of short-term and long-term borrowings are estimated using discounted cash flow analyses based on the Corporation's incremental borrowing rate for similar instruments.

Commitments to Extend Credit and Standby Letters of Credit

Management estimates that there are no material differences between the notional amount and the estimated fair value of those off-balance sheet items since they are primarily composed of unfunded loan commitments which are generally priced at market at the time of funding.

At December 31, 2002 and 2001, the carrying values and estimated fair values of financial instruments of the Corporation are presented in the table below:

	2002		2001	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
FINANCIAL ASSETS:				
Cash and due from banks	\$ 7,396,004	\$ 7,396,004	\$ 6,500,362	\$ 6,500,362
Short-term investments	60,060	60,060	49,975	50,001
Investment securities	215,754,998	220,775,066	184,107,232	183,706,816
Net loans	198,342,876	201,619,853	195,301,883	197,826,799
Accrued interest receivable	3,068,952	3,068,952	2,993,904	2,993,904
Cash Surrender Value of Life Insurance	10,102,069	10,102,069	0	0
FINANCIAL LIABILITIES:				
Deposits	330,745,278	331,708,248	294,680,823	292,945,385
Short-term borrowings	9,067,145	9,065,644	11,566,364	11,705,247
Long-term borrowings	45,750,000	52,186,009	45,250,000	50,264,298
Accrued interest payable	952,459	952,459	1,067,305	1,067,305
OFF-BALANCE SHEET FINANCIAL INSTRUMENTS:				
Commitments to extend credit		24,742,078		21,853,237
Standby letters of credit		3,630,215		2,588,989

Note 20 Parent Company Financial Information

Condensed financial information for First Keystone Corporation (parent company only) was as follows:

BALANCE SHEETS

	December 31	
	2002	2001
ASSETS		
Cash in subsidiary bank	\$ 495,051	\$ 410,641
Investment in subsidiary bank	47,205,639	37,689,525
Investment in other equity securities	2,001,070	1,875,030
Prepayments and other assets	239,594	200
Advance to Subsidiary Bank	-	126,069
TOTAL ASSETS	\$49,941,354	\$40,101,465
LIABILITIES		
Accrued expenses and other liabilities	\$ 598,539	\$ 405,588
Advance from subsidiary bank	246,774	-
TOTAL LIABILITIES	\$ 845,313	\$ 405,588
STOCKHOLDERS' EQUITY		
Preferred stock	\$ -	\$ -
Common stock	6,150,360	5,867,454
Surplus	12,583,626	9,761,066
Retained earnings	27,394,962	26,449,437
Accumulated other comprehensive income	6,543,981	714,601
Treasury stock, at cost	(3,576,888)	(3,096,681)
TOTAL STOCKHOLDERS' EQUITY	\$49,096,041	\$39,695,877
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$49,941,354	\$40,101,465

STATEMENTS OF INCOME

	Year Ended December 31		
	2002	2001	2000
INCOME			
Dividends from Subsidiary Bank	\$2,757,703	\$2,376,319	\$2,346,982
Dividends - other	53,715	49,598	54,699
Securities gains	17,160	89,048	129,998
Interest	7,972	9,000	5,666
TOTAL INCOME	\$2,836,550	\$2,523,965	\$2,537,345
Operating Expenses	41,145	52,219	60,019
Income Before Taxes and Equity in			
Undistributed Net Income of Subsidiary	\$2,795,405	\$2,471,746	\$2,477,326
Income tax expense	41	24,644	37,456
Income Before Equity in Undistributed Net			
Income of Subsidiary	\$2,795,364	\$2,447,102	\$2,439,870
Equity in undistributed net income of Subsidiary	3,791,785	2,986,299	2,768,237
NET INCOME	\$6,587,149	\$5,433,401	\$5,208,107

STATEMENTS OF CASH FLOWS

	Year Ended December 31		
	2002	2001	2000
OPERATING ACTIVITIES			
Net income	\$ 6,587,149	\$ 5,433,401	\$ 5,208,107
Adjustments to reconcile net income to net cash provided by operating activities:			
Securities gains	(17,160)	(89,048)	(129,998)
Equity in undistributed net income of Subsidiary	(3,791,785)	(2,986,299)	(2,768,237)
(Increase) decrease in prepaid expenses and other assets	(239,394)	4,082	88,701
(Increase) decrease in advanced receivable from Subsidiary Bank	126,069	(57,835)	(68,234)
Increase (decrease) in advances payable to Subsidiary Bank	246,774	-	(99,742)
Increase (decrease) in accrued expenses and other liabilities	121,169	132,047	8,566
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 3,032,822</u>	<u>\$ 2,436,348</u>	<u>\$ 2,239,163</u>
INVESTING ACTIVITIES			
Purchase of equity securities	\$ (37,340)	\$ (89,482)	\$ (314,936)
Proceeds from sale of equity securities	105,293	144,255	243,656
NET CASH PROVIDED (USED) IN INVESTING ACTIVITIES	<u>\$ 67,953</u>	<u>\$ 54,773</u>	<u>\$ (71,280)</u>
FINANCING ACTIVITIES			
Proceeds from sale of treasury stock for employee stock option plan	\$ 17,000	\$ -	\$ -
Acquisition of treasury stock	(503,707)	-	-
Cash dividends paid	(2,524,933)	(2,295,319)	(2,181,970)
Dividends paid in lieu of fractional shares	(4,725)	-	-
NET CASH (USED) BY FINANCING ACTIVITIES	<u>\$ (3,016,365)</u>	<u>\$ (2,295,319)</u>	<u>\$ (2,181,970)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ 84,410	\$ 195,802	\$ (14,087)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>410,641</u>	<u>214,839</u>	<u>228,926</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 495,051</u>	<u>\$ 410,641</u>	<u>\$ 214,839</u>

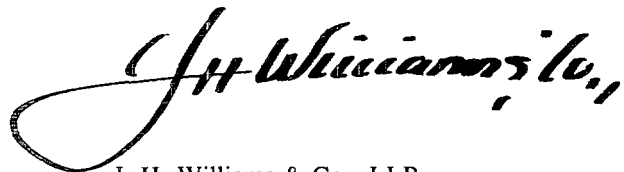
REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

BOARD OF DIRECTORS AND STOCKHOLDERS OF FIRST KEYSTONE CORPORATION:

We have audited the accompanying consolidated balance sheets of First Keystone Corporation and Subsidiary as of December 31, 2002 and 2001, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Keystone Corporation and Subsidiary as of December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.



J. H. Williams & Co., LLP

Kingston, Pennsylvania
January 13, 2003

MANAGEMENT'S STATEMENT OF RESPONSIBILITY

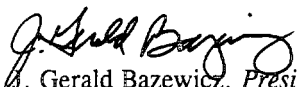
TO OUR STOCKHOLDERS:

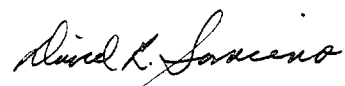
The management of First Keystone Corporation is responsible for the preparation, integrity and the objectivity of the consolidated financial statements and other financial information presented in this annual report. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect the effects of certain estimates and judgments made by management.

The Corporation's management maintains an effective system of internal control that is designed to provide reasonable assurance that assets are safe-guarded and transactions are properly recorded and executed in accordance with management's authorization. The system is continuously monitored by direct management review and by internal auditors who conduct an effective program of internal audits. The Corporation selects and trains qualified people who are provided with and expected to adhere to its standards of business conduct. These standards which set forth the highest principles of business ethics and conduct are a key element of the Corporation's control system.

The consolidated financial statements of the Corporation have been audited by J. H. Williams & Co., LLP, Independent Certified Public Accountants. Their audits were conducted in accordance with auditing standards generally accepted in the United States of America and included a review of the internal control structure and such other procedures and tests of the accounting records as they considered necessary in the circumstances.

The Audit Committee of the Board of Directors, which consists of five outside directors, meets regularly with management, the internal auditors, and the independent certified public accountants to review accounting, reporting, and internal control matters. The Audit Committee has direct and private access to both internal and external auditors.


J. Gerald Bazewicz, President & CEO


David R. Saracino, Treasurer & Assistant Secretary

Berwick, Pennsylvania
March 7, 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The purpose of Management's Discussion and Analysis of First Keystone Corporation, a bank holding company (the Corporation), and its wholly owned subsidiary, The First National Bank of Berwick (the Bank), is to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data contained herein.

This annual report contains certain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995), which reflect management's beliefs and expectations based on information currently available. These forward-looking statements are inherently subject to significant risks and uncertainties, including changes in general economic and financial market conditions, the Corporation's ability to effectively carry out its business plans and changes in regulatory or legislative requirements. Other factors that could cause or contribute to such differences are changes in competitive conditions. Although management believes the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

RESULTS OF OPERATIONS

Year Ended December 31, 2002 Versus Year Ended December 31, 2001

Net income increased to \$6,587,000 for the year ended December 31, 2002, as compared to \$5,433,000 for the prior year. The net income for 2002 marked the 20th consecutive year that earnings and earnings per share have increased. Earnings per share, both basic and diluted, for 2002 were \$2.22 and \$2.21, respectively, as compared to \$1.83 in 2001.

The Corporation's return on average assets increased to 1.59% in 2002 from 1.41% in 2001. In addition, the return on average equity increased to 14.93% in 2002 from 13.85% in 2001. Even though there was an increase in average earning assets in 2002, the low interest rate environment resulted in an overall decrease of interest income to \$25,862,000 down 3.6% from 2001. A lowering of interest rates and the accompanying decrease in the cost of funds resulted in interest expense of \$11,342,000 in 2002, a decrease of 21.6% from 2001.

Net interest income, as indicated below in Table 1, increased by \$2,149,000 or 17.4% to \$14,520,000 for the year ended December 31, 2002. The Corporation's net interest income on a fully taxable equivalent basis increased \$2,213,000, or 16.0% to \$16,029,000 in 2002 as compared to an increase of \$387,000, or 2.9% to \$13,816,000 in 2001.

Year Ended December 31, 2001 Versus Year Ended December 31, 2000

Net income increased to \$5,433,000 for the year ended December 31, 2001, as compared to \$5,208,000 in 2000. Earnings per share, both basic and diluted, for 2001 were \$1.83 as compared to \$1.75 in 2000. The Corporation's return on average assets and return on average equity was 1.41% and 13.85%, respectively in 2001, as compared to 1.52% and 16.55%, respectively in 2000.

Net interest income increased by \$716,000 or 6.1% to \$12,371,000 for the year ended 2001. The Corporation's net interest income on a fully taxable equivalent basis increased 2.9% in 2001 or \$387,000 to \$13,816,000 as indicated in Table 1 as compared to \$13,429,000 for the year ended 2000.

Table 1 • Net Interest Income

(Amounts in thousands)

	2002/2001			2001/2000		
	Increase/(Decrease)			Increase/(Decrease)		
	2002	Amount	%	2001	Amount	%
Interest Income	\$25,862	\$ (974)	(3.6)	\$26,836	\$1,186	4.6
Interest Expense	11,342	(3,123)	(21.6)	14,465	470	3.4
Net Interest Income	14,520	2,149	17.4	12,371	716	6.1
Tax Equivalent Adjustment	1,509	64	4.4	1,445	(329)	(18.5)
Net Interest Income (fully tax equivalent)	<u>\$16,029</u>	<u>\$ 2,213</u>	16.0	<u>\$13,816</u>	<u>\$ 387</u>	2.9

Table 2 • Distribution of Assets, Liabilities and Stockholders' Equity

	2002		
	Avg. Balance	Revenue/Expense	Yield/Rate
Interest Earning Assets:			
Loans:			
Commercial ¹	\$ 28,279,604	\$ 1,790,057	6.33%
Real Estate ¹	146,707,839	10,929,533	7.45%
Installment Loans, Net ^{1,2}	26,159,391	2,269,464	8.68%
Fees on Loans	0	117,830	0%
Total Loans (Including Fees) ³	<u>\$201,146,834</u>	<u>\$15,106,884</u>	<u>7.51%</u>
Investment Securities:			
Taxable	\$ 141,884,015	\$ 8,212,523	5.79%
Tax Exempt ¹	52,610,989	3,774,219	7.17%
Total Investment Securities	<u>\$194,495,004</u>	<u>\$11,986,742</u>	<u>6.16%</u>
Interest Bearing Deposits in Banks	5,193,664	78,211	1.51%
Total Interest-Earning Assets	<u>\$400,835,502</u>	<u>\$27,171,837</u>	<u>6.78%</u>
Non-Interest Earning Assets:			
Cash and Due From Banks	\$ 6,619,448		
Allowance for Loan Losses	(3,060,762)		
Premises and Equipment	3,364,978		
Foreclosed Assets Held for Sale	26,224		
Other Assets	6,260,316		
Total Non-Interest Earning Assets	<u>13,210,204</u>		
Total Assets	<u>\$414,045,706</u>		
Interest-Bearing Liabilities:			
Savings, NOW Accounts, and Money Markets	\$ 123,269,195	\$ 1,844,737	1.50%
Time Deposits	161,261,870	6,271,880	3.89%
Short-Term Borrowings	1,378,545	25,125	1.82%
Long-Term Borrowings	46,929,744	3,078,389	6.56%
Securities Sold U/A to Repurchase	6,357,032	121,489	1.91%
Total Interest-Bearing Liabilities	<u>\$339,196,386</u>	<u>\$11,341,620</u>	<u>3.34%</u>
Non-Interest Bearing Liabilities:			
Demand Deposits	\$ 27,401,124		
Other Liabilities	3,317,857		
Stockholders' Equity	44,130,339		
Total Liabilities/Stockholders' Equity	<u>\$414,045,706</u>		
Net Interest Income Tax Equivalent		<u>\$15,830,217</u>	
Net Interest Spread			3.44%
Net Interest Margin			3.95%

¹Tax-exempt income has been adjusted to a tax equivalent basis using an incremental rate of 34%, and statutory interest expense disallowance.

²Installment loans are stated net of unearned interest.

³Average loan balances include non-accrual loans. Interest income on non-accrual loans is not included.

2001			2000		
Avg. Balance	Revenue/Expense	Yield/Rate	Avg. Balance	Revenue/Expense	Yield/Rate
\$ 27,392,753	\$ 2,048,474	7.48%	\$ 17,409,129	\$ 1,796,792	10.32%
139,085,901	11,289,600	8.12%	138,855,558	11,487,524	8.27%
28,006,285	2,566,160	9.16%	31,376,389	2,695,065	8.59%
-	64,923	0%	0	28,438	0%
<u>\$194,484,939</u>	<u>\$15,969,157</u>	<u>8.21%</u>	<u>\$187,641,076</u>	<u>\$16,007,819</u>	<u>8.53%</u>
\$127,746,749	\$ 8,285,399	6.49%	\$ 93,011,187	\$ 6,566,028	7.06%
47,343,277	3,599,148	7.60%	48,778,533	4,627,941	9.49%
<u>\$175,090,026</u>	<u>\$11,884,547</u>	<u>6.79%</u>	<u>\$141,789,720</u>	<u>\$11,193,969</u>	<u>7.89%</u>
5,841,066	228,391	3.91%	59,731	7,404	12.40%
<u>\$375,416,031</u>	<u>\$28,082,095</u>	<u>7.48%</u>	<u>\$329,490,527</u>	<u>\$27,209,192</u>	<u>8.26%</u>
\$ 6,179,589			\$ 6,881,283		
(2,687,787)			(2,599,044)		
3,419,464			3,751,007		
171,911			0		
<u>3,605,284</u>			<u>4,724,690</u>		
<u>10,688,461</u>			<u>12,757,936</u>		
<u>\$386,104,492</u>			<u>\$342,248,463</u>		
\$114,253,426	\$ 3,115,844	2.73%	\$101,727,428	\$ 3,273,578	3.22%
155,627,518	8,574,970	5.51%	134,872,486	7,698,813	5.71%
1,017,907	35,892	3.53%	14,449,813	935,108	6.47%
41,439,394	2,427,519	5.86%	27,558,202	1,705,032	6.19%
<u>8,008,903</u>	<u>310,835</u>	<u>3.88%</u>	<u>7,734,721</u>	<u>382,828</u>	<u>4.95%</u>
<u>\$320,347,148</u>	<u>\$14,465,060</u>	<u>4.52%</u>	<u>\$286,342,650</u>	<u>\$13,995,359</u>	<u>4.89%</u>
\$ 23,647,180			\$ 22,277,061		
2,892,640			2,158,311		
<u>39,217,524</u>			<u>31,470,441</u>		
<u>\$386,104,492</u>			<u>\$342,248,463</u>		
	<u>\$13,617,035</u>			<u>\$13,213,833</u>	
		2.96%			3.37%
		3.63%			4.01%

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income. Net interest income is the difference between interest income on earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, including deposits and other borrowings. The amount of interest income is dependent upon both the volume of earning assets and the level of interest rates. In addition, the volume of non-performing loans affects interest income. The amount of interest expense varies with the amount of funds needed to support earning assets, interest rates paid on deposits and borrowed funds, and finally, the level of interest free deposits.

Table 2 on the preceding pages provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and expense as well as average tax equivalent rates earned and paid as of year-end 2002, 2001, and 2000.

The yield on earning assets was 6.78% in 2002, 7.48% in 2001, and 8.26% in 2000. The rate paid on interest bearing liabilities was 3.34% in 2002, 4.52% in 2001, and 4.89% in 2000. A 70 basis point decrease in the yield on earning assets was more than offset by a 118 basis point decrease on the rate paid on interest bearing liabilities in 2002. This resulted in an increase in our net interest margin.

The net interest margin, which is interest income less interest expenses divided by average earnings assets, was 3.95% in 2002 as compared to 3.63% in 2001 and 4.01% in 2000. The net interest margins are presented on a tax-equivalent basis. The increase in net interest margin was due primarily to the interest rate on earning assets decreasing less than the interest rate on liabilities. The net interest margin would have improved even more in 2002; however, the Corporation elected to prepay some higher rate long-term borrowings with the Federal Home Loan Bank. The penalty assessed on the prepayment resulted in the overall effective rate on long-term borrowings increasing to 6.56% from 5.86% in 2001 as illustrated in Table 2. This action, while temporarily increasing the cost of long-term borrowings in 2002 will help control the future overall cost of liabilities.

Table 3 sets forth changes in interest income and interest expense for the periods indicated for each category of interest earning assets and interest bearing liabilities. Information is provided on changes attributable to (i) changes in volume (changes in average volume multiplied by prior rate); (ii) changes in rate (changes in average rate multiplied by prior average volume); and, (iii) changes in rate and volume (changes in average volume multiplied by change in average rate).

Table 3 • Changes in Income and Expense, 2002 and 2001

(Amounts in thousands)	2002 COMPARED TO 2001			2001 COMPARED TO 2000		
	VOLUME	RATE	NET	VOLUME	RATE	NET
Interest Income:						
Loans, Net	\$ 548	\$ (1,409)	\$ (861)	\$ 584	\$ (617)	\$ (33)
Taxable Investment Securities	889	(714)	175	2,452	(981)	1,471
Tax-Exempt Investment Securities	420	(245)	175	(142)	(909)	(1,051)
Other Short-Term Investments	(221)	(178)	(399)	1,191	(721)	470
Total Interest Income	<u>\$ 1,636</u>	<u>\$ (2,546)</u>	<u>\$ (910)</u>	<u>\$ 4,085</u>	<u>\$ (3,228)</u>	<u>\$ 857</u>
Interest Expense:						
Savings, Now, and Money Markets	\$ 246	\$ (1,517)	\$ (1,271)	\$ 403	\$ (561)	\$ (158)
Time Deposits	310	(2,614)	(2,304)	1,185	(309)	876
Short-Term Borrowings	13	(23)	(10)	(869)	(30)	(899)
Long-Term Borrowings	322	329	651	859	(136)	723
Securities Sold U/A to Repurchase	(64)	(125)	(189)	14	(86)	(72)
Total Interest Expense	<u>\$ 827</u>	<u>\$ (3,950)</u>	<u>\$ (3,123)</u>	<u>\$ 1,592</u>	<u>\$ (1,122)</u>	<u>\$ 470</u>
Net Interest Income	<u>\$ 809</u>	<u>\$ 1,404</u>	<u>\$ 2,213</u>	<u>\$ 2,493</u>	<u>\$ (2,106)</u>	<u>\$ 387</u>

The change in interest due to both volume and yield/rate has been allocated to change due to volume and change due to yield/rate in proportion to the absolute value of the change in each.

Balance on non-accrual loans are included for computational purposes. Interest income on non-accrual loans is not included. Interest income exempt from federal tax was \$2,928,225 in 2002, \$2,804,205 in 2001, and \$3,442,834 in 2000. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34%.

In 2002, the increase in net interest income of \$2,213,000 resulted from a change in volume of \$809,000 and an increase of \$1,404,000 due to changes in rate. In 2001, there was an increase in net interest income of \$387,000 resulted from a change in volume of \$2,493,000 and a decrease of \$2,106,000 due to rate.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2002, the provision for loan losses was \$550,000 as compared to \$610,000 as of December 31, 2001, a decrease of 9.8%. The Corporation's provision for loan losses for the year ended December 31, 2000, was \$425,000. The provision in 2002, decreased primarily because of the reduced net charge-offs and the decrease in past-due loans and non-performing loans. Net charge-offs by the Corporation for the fiscal year end December 31, 2002, 2001, and 2000, were \$297,000, \$390,000, and \$323,000, respectively.

The allowance for loan losses as a percentage of loans, net of unearned interest, was 1.58% as of December 31, 2002, 1.47% as of December 31, 2001, and 1.42% as of December 31, 2000.

On a quarterly basis, the Corporation's Board of Directors and management performs a detailed analysis of the adequacy of the allowance for loan losses. This analysis includes an evaluation of credit risk concentration, delinquency trends, past loss experience, current economic conditions, composition of the loan portfolio, classified loans and other relevant factors.

The Corporation will continue to monitor its allowance for loan losses and make future adjustments to the allowance through the provision for loan losses as conditions warrant. Although the Corporation believes that the allowance for loan losses is adequate to provide for losses inherent in the loan portfolio, there can be no assurance that future losses will not exceed the estimated amounts or that additional provisions will not be required in the future.

The Bank is subject to periodic regulatory examination by the Office of the Comptroller of the Currency (OCC). As part of the examination, the OCC will assess the adequacy of the bank's allowance for loan losses and may include factors not considered by the Bank. In the event that an OCC examination results in a conclusion that the Bank's allowance for loan losses is not adequate, the Bank may be required to increase its provision for loan losses.

NON-INTEREST INCOME

Non-interest income is derived primarily from trust department revenue, service charges and fees, other miscellaneous revenue and the gain on the sale of mortgage loans. In addition, investment security gains or losses also impact total non-interest income.

For the year ended December 31, 2002, non-interest income decreased \$60,000, or 2.6% as compared to an increase of \$470,000, or 25.1% for the year ended December 31, 2001. Table 4 provides the major categories of non-interest income and each respective change comparing the past three years.

Excluding investment security gains, non-interest income in 2002 increased \$189,000, or 9.1%. This compares to an increase of \$305,000, or 17.3% in 2001 before investment security gains. Income from the trust department, which consists of fees generated from individual and corporate accounts, decreased in 2002 by \$45,000 after decreasing by \$16,000 in 2001. Decreased income from the trust department in 2002 and 2001 was due primarily to the decline in market value of accounts.

Service charges and fees, consisting primarily of service charges on deposit accounts, was the largest source of non-interest income in 2002 and 2001. Service charges and fees increased by \$141,000, or 11.4% in 2002 compared to an increase of \$139,000, or 12.7% in 2001. The increase resulted from higher fees from increased debit card usage, an increase in ATM surcharges, and an increase in overdraft fees.

Other income increased by \$49,000, or 51.0% in 2002 compared to an increase of \$56,000, or 140.0% in 2001. In October 2002, the Bank purchased \$10 million of Bank Owned Life Insurance ("BOLI"). The income from BOLI represents the increase in the cash surrender value of BOLI and is intended to partially cover the costs of the Bank's employee benefit plan, including group life, disability, and health insurance. Income from BOLI totaled \$102,000 in 2002 and is included in other income.

The gain on sale of mortgages provided \$228,000 in 2002, an increase of \$44,000 over 2001. The increase in gains on sale of mortgages was largely a function of the increased volume of mortgages originated for sale in the secondary market during the past year. Since the Corporation continues to service the mortgages which are sold, this provides a source for additional non-interest income on an ongoing basis.

Table 4 • Non-Interest Income

(Amounts in thousands)	2002/2001			2001/2000			
	2002	Increase/(Decrease)		2001	Increase/(Decrease)		
		Amount	%		Amount	%	
Trust Department	\$ 510	\$ (45)	(8.1)	\$ 555	\$ (16)	(2.8)	\$ 571
Service Charges and Fees	1,373	141	11.4	1,232	139	12.7	1,093
Other	145	49	51.0	96	56	140.0	40
Gain on Sale of Mortgages	<u>228</u>	<u>44</u>	23.9	<u>184</u>	<u>126</u>	217.2	<u>58</u>
Subtotal	\$2,256	\$189	9.1	\$2,067	\$305	17.3	\$1,762
Investment Securities Gains	<u>29</u>	<u>(249)</u>	(89.6)	<u>278</u>	<u>165</u>	146.0	<u>113</u>
Total	<u>\$2,285</u>	<u>\$ (60)</u>	(2.6)	<u>\$2,345</u>	<u>\$470</u>	25.1	<u>\$1,875</u>

NON-INTEREST EXPENSE

Non-interest expense consists of salaries and benefits, occupancy, furniture and equipment, and other miscellaneous expenses. Table 5 provides the yearly non-interest expense by category, along with the amount, dollar changes, and percentage of change.

Total non-interest expense increased by \$630,000, or 8.8% in 2002 compared to an increase of \$394,000, or 5.8% in 2001. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to 54.1% of total non-interest expense in 2002 and 54.3% in 2001. Salaries and employee benefits increased \$326,000, or 8.4% in 2002 and \$134,000, or 3.6% in 2001. The increase in both years were due to an increase in the profit sharing contribution, plus normal salary adjustments and increased benefit costs. In addition, staffing increased in 2002 with the opening of our tenth full service office in Kingston, Pennsylvania. Full time equivalent employees total 131 as of December 31, 2002, and 123 as of December 31, 2001.

Net occupancy expense increased \$39,000, or 8.7% in 2002 as compared to an increase of \$16,000, or 3.7% in 2001. Furniture and equipment expense increased \$48,000, or 8.5% in 2002 compared to a decrease of \$2,000, or a decrease of 0.4% in 2001. The increase in furniture and equipment expense in 2002 relates to new purchases of furniture and equipment primarily for our Kingston Office. Other operating expenses increased \$217,000, or 9.6% in 2002 as compared to an increase of \$246,000, or 12.2% in 2001. Increases in professional fees, postage, supplies, insurance, marketing, advertising, and state shares tax account for much of the increase in other operating expenses.

The overall level of non-interest expense continues to below, relative to our peers. In fact, our total non-interest expense was less than 2% of average assets in both 2002 and 2001. Non-interest expense as a percentage of average assets under 2% places us among the leaders in our peer financial institution categories in controlling non-interest expense.

Table 5 • Non-Interest Expense

(Amounts in thousands)	<u>2002/2001</u>			<u>2001/2000</u>			
		<u>Increase/(Decrease)</u>			<u>Increase/(Decrease)</u>		
	<u>2002</u>	<u>Amount</u>	<u>%</u>	<u>2001</u>	<u>Amount</u>	<u>%</u>	<u>2000</u>
Salaries and Employee Benefits	\$4,222	\$326	8.4	\$3,896	\$134	3.6	\$3,762
Occupancy, Net	486	39	8.7	447	16	3.7	431
Furniture and Equipment	616	48	8.5	568	(2)	(0.4)	570
Other and State Shares Tax	<u>2,487</u>	<u>217</u>	9.6	<u>2,270</u>	<u>246</u>	12.2	<u>2,024</u>
Total	<u>\$7,811</u>	<u>\$630</u>	8.8	<u>\$7,181</u>	<u>\$394</u>	5.8	<u>\$6,787</u>

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2002, was \$1,857,000 as compared to \$1,493,000 and \$1,110,000 for the years ended December 31, 2001, and December 31, 2000, respectively. In 2002, our income tax expense increased because income before taxes increased \$1,517,000 to \$8,444,000 from \$6,927,000 in 2001. In 2001, our income before taxes increased \$608,000 as compared to 2000. An increase in tax exempt interest, derived from both our tax-free loans and tax free municipal investment securities in 2000, resulted in a lower income tax liability. The effective income tax rate was 22.0% in 2002, 21.5% in 2001, and 17.4% in 2000. The limited availability of tax free municipal investments at attractive interest rates may result in a higher effective tax rate in future years.

FINANCIAL CONDITION

GENERAL

Total assets increased to \$439,526,000, at year-end 2002, an increase of 11.7% over year-end 2001. As of December 31, 2002, total deposits amounted to \$330,745,000, an increase of 12.2% over 2001. Assets as of December 31, 2001, were \$393,472,000, an increase of 9.2% over 2000, while total deposits as of year-end 2001 amounted to \$294,681,000, an increase of 8.5% from 2000.

In 2002, the increase in assets primarily reflects the deployment of deposits into loans and investment securities. The Corporation continues to maintain and manage its asset growth. Our strong equity capital position provides us an opportunity to further leverage our asset growth. Borrowings decreased in 2002 by \$1,999,000 after increasing in 2001 by \$7,007,000. Strong deposit growth in 2002 allowed us to attain our targeted total asset level without an increase in borrowings. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals are our most significant source of funds. In 2002 and 2001, several successful sales campaigns attracted new customers and generated growth in retail certificates of deposit (time deposits of individuals).

EARNING ASSETS

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 97.2% for 2002, compared to 97.2% for 2001, and 97.0% for 2000. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

LOANS

Total loans, net of unearned income, increased to \$201,517,000 as of December 31, 2002, as compared to \$198,224,000 as of December 31, 2001. Table 6 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans, net of unearned income increased \$3,293,000, or 1.7% in 2002 compared to an increase of \$7,553,000, or 4.0% in 2001.

The loan portfolio is well diversified and increases in the portfolio in 2002 were in commercial real estate and real estate loans (primarily residential mortgage loans). In 2001, the increase in loans was primarily in commercial loans and tax exempt loans. Real estate loans increased in 2002, even though we sold residential mortgage loans in the secondary market. The Corporation will continue to originate and sell long-term fixed rate residential mortgage loans which conform to secondary market requirements. The Corporation derives ongoing income from the servicing of mortgages sold in the secondary market.

The noted loan growth was achieved without compromising loan quality. The Corporation internally underwrites each of its loans to comply with prescribed policies and approval levels established by its Board of Directors.

Table 6 • Loans Outstanding, Net of Unearned Income

(Amounts in thousands)	December 31,				
	2002	2001	2000	1999	1998
Commercial, financial and agricultural:					
Commercial secured by real estate	\$ 65,352	\$ 61,135	\$ 53,608	\$ 55,514	\$ 43,366
Commercial - other	23,639	24,062	22,674	17,864	16,579
Tax exempt	4,393	7,958	3,798	4,133	2,254
Real estate (primarily residential mortgage loans)	85,145	79,483	84,330	83,099	77,858
Consumer loans	<u>28,640</u>	<u>32,075</u>	<u>32,845</u>	<u>30,595</u>	<u>26,205</u>
Total Gross Loans	\$207,169	\$204,713	\$197,255	\$191,205	\$166,262
Less: Unearned income and unamortized loan fees net of costs	<u>5,652</u>	<u>6,489</u>	<u>6,583</u>	<u>5,974</u>	<u>4,729</u>
Total Loans, net of unearned income	<u>\$201,517</u>	<u>\$198,224</u>	<u>\$190,672</u>	<u>\$185,231</u>	<u>\$161,533</u>

INVESTMENT SECURITIES

The Corporation uses investment securities to not only generate interest and dividend revenue, but also to help manage interest rate risk and to provide liquidity to meet operating cash needs.

The investment portfolio has been allocated between securities available for sale and securities held to maturity. No investment securities were established in a trading account. Available for sale securities increased to \$209,823,000 in 2002, a 17.8% increase over 2001. At December 31, 2002, the net unrealized gain, net of the tax effect, on these securities was \$6,544,000 and is included in stockholders' equity as accumulated other comprehensive gain. At December 31, 2001, accumulated other comprehensive income, net of tax effect, amounted to \$715,000. In 2002, held-to-maturity securities declined \$77,000, or a 1.3% decrease from 2001 after declining \$2,728,000, or a 31.2% decrease in 2001. Table 7 provides data on the carrying value of our investment portfolio on the

dates indicated. The vast majority of investment security purchases are allocated as available-for-sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate an investment security.

The investment portfolio includes U.S. Government Corporations and Agencies, corporate obligations, mortgage backed securities, state and municipal securities, and other debt securities. In addition, the investment portfolio includes restricted equity securities consisting primarily of common stock investments in the Federal Reserve Bank and the Federal Home Loan Bank, and marketable equity securities of other commercial banks and bank holding companies.

Securities available-for-sale may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on our statements of income. The investment portfolio does not contain any structured notes, step-up bonds, or any off-balance sheet derivatives.

Table 7 • Carrying Value of Investment Securities

(Amounts in thousands)	December 31,					
	2002		2001		2000	
	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity
U. S. Government Corporations and Agencies	\$ 77,806	\$ 4,272	\$ 55,267	\$ 5,332	\$ 66,421	\$ 6,947
State and Municipal	84,809	1,660	74,184	677	58,698	1,790
Corporate	38,446	0	41,334	0	13,505	0
Marketable Equity Securities	5,310	0	4,286	0	3,600	0
Restricted Equity Securities	<u>3,452</u>	<u>0</u>	<u>3,027</u>	<u>0</u>	<u>5,477</u>	<u>0</u>
Total Investment Securities	<u>\$209,823</u>	<u>\$ 5,932</u>	<u>\$178,098</u>	<u>\$ 6,009</u>	<u>\$147,701</u>	<u>\$ 8,737</u>

During 2002, interest bearing deposits in other banks increased to \$60,000 from \$50,000 in 2001. Balances in interest bearing deposits in other banks were kept relatively low as funds were invested in marketable securities to maximize income while still addressing liquidity needs.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2002, the allowance for loan losses was \$3,175,000 as compared to the December 31, 2001, amount of \$2,922,000 and the December 31, 2000, amount of \$2,702,000. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectibility of the principal is unlikely. The risk characteristics of the loan portfolio are managed through the various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific and general allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. This assessment results in an allocated allowance. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority.

Management feels based upon its methodology, that the allowance for loan losses is adequate to cover foreseeable future losses. Table 8 contains an analysis of our Allowance for Loan Losses indicating charge-offs and recoveries by the year. In 2002, net charge-offs as a percentage of average loans were .15% compared to .20% in 2001 and .17% in 2000. Net charge-offs amounted to \$297,000 in 2002 as compared to \$390,000 and \$323,000 in 2001 and 2000, respectively.

Table 8 • Analysis of Allowance for Loan Losses

(Amounts in thousands)	Years Ended December 31,				
	2002	2001	2000	1999	1998
Balance at beginning of period	\$ 2,922	\$ 2,702	\$ 2,600	\$ 2,421	\$ 2,371
Charge-offs:					
Commercial, financial, and agricultural	66	109	79	25	66
Real estate - mortgage	140	111	44	20	42
Installment loans to individuals	<u>196</u>	<u>238</u>	<u>226</u>	<u>213</u>	<u>161</u>
	402	458	349	258	269
Recoveries:					
Commercial, financial, and agricultural	1	21	0	23	0
Real estate - mortgage	77	3	10	62	8
Installment loans to individuals	<u>27</u>	<u>44</u>	<u>16</u>	<u>27</u>	<u>36</u>
	105	68	26	112	44
Net charge-offs	297	390	323	146	225
Additions charged to operations	<u>550</u>	<u>610</u>	<u>425</u>	<u>325</u>	<u>275</u>
Balance at end of period	<u>\$ 3,175</u>	<u>\$ 2,922</u>	<u>\$ 2,702</u>	<u>\$ 2,600</u>	<u>\$ 2,421</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	.15%	.20%	.17%	.08%	.15%
Allowance for loan losses to average loans outstanding during the period	1.58%	1.50%	1.44%	1.49%	1.57%

It is the policy of management and the Corporation's Board of Directors to provide for losses on both identified and unidentified losses inherent in its loan portfolio. A provision for loan losses is charged to operations based upon an evaluation of the potential losses in the loan portfolio. This evaluation takes into account such factors as portfolio concentrations, delinquency, trends, trends of non-accrual and classified loans, economic conditions, and other relevant factors.

The loan review process which is conducted quarterly, is an integral part of our evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation's allowance for loan losses is reviewed by our Board of Directors.

With our manageable level of net charge-offs and the additions to the reserve from our provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.58% to 2002, 1.50% in 2001, and 1.44% in 2000.

Table 9 sets forth the allocation of the Bank's allowance for loan losses by loan category and the percentage of loans in each category to total loans receivable at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

Table 9 • Allocation of Allowance for Loan Losses

(Amounts in thousands)	December 31,									
	2002	%*	2001	%*	2000	%*	1999	%*	1998	%*
Commercial, financial, and agricultural	\$ 488	12.4	\$ 605	14.9	\$ 316	10.7	\$ 308	11.2	\$ 253	9.8
Real estate - mortgage	1,812	75.0	1,826	71.2	1,606	71.1	1,431	75.5	1,237	74.3
Consumer and other loans	357	12.6	458	13.9	557	18.2	425	13.3	319	15.9
Unallocated	518	N/A	33	N/A	223	N/A	436	N/A	612	N/A
	<u>\$3,175</u>	<u>100.0</u>	<u>\$2,922</u>	<u>100.0</u>	<u>\$2,702</u>	<u>100.0</u>	<u>\$2,600</u>	<u>100.0</u>	<u>\$2,421</u>	<u>100.0</u>

*Percentage of loans in each category to total loans.

NON-PERFORMING ASSETS

Even with the continuing economic slowdown in 2002, the Corporation experienced a decrease in delinquencies and non-performing loans. Table 10 details the Corporation's non-performing assets at the dates indicated.

Non-accrual loans are generally delinquent on which principal or interest is past-due approximately 90 days or more, depending upon the type of credit and the collateral. When a loan is placed on non-accrual status, any unpaid interest is charged against income. Restructured loans are loans where the borrower has been granted a concession in the interest rate or payment amount because of financial problems. Foreclosed assets held for sale represents property acquired through foreclosure, or considered to be an in-substance foreclosure.

The total of non-performing assets decreased to \$458,000 as of December 31, 2002, as compared to \$1,394,000 as of December 31, 2001. Non-accrual and restructured loans decreased from \$1,102,000 in 2001 to \$458,000 in 2002. Foreclosed assets decreased to zero from \$75,000 in 2001. Loans past-due 90 days or more and still accruing also decreased to zero in 2002 from \$217,000 in

2001. Our allowance for loan losses to total non-performing assets remains very strong at 693.7% in 2002 as compared to 209.6% in 2001. We continue to rank well ahead of peer banks on measurements of delinquency.

Loan quality is monitored closely, and we actively work with borrowers to resolve credit problems. Excluding the assets disclosed in Table 10, management is not aware of any information about borrowers' possible credit problems, which cause serious doubt as to their ability to comply with present loan repayment terms.

Should the economic climate no longer continue to be stable or begin to deteriorate, borrowers may experience difficulty, and the level of non-performing loans and assets, charge-offs and delinquencies could rise and possibly require additional increases in our allowance for loan losses.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for possible loan and lease losses. They may require additions to allowances based upon their judgements about information available to them at the time of examination.

Interest income received on non-performing loans in 2002 and 2001 was \$19,179 and \$72,382, respectively. Interest income, which would have been recorded on these loans under the original terms in 2002 and 2001 was \$38,956 and \$93,258, respectively. At December 31, 2002, the Corporation had no outstanding commitments to advance additional funds with respect to these non-performing loans.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2002, 2001 and 2000, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 10 • Non-Performing Assets

(Amounts in thousands)	December 31,				
	2002	2001	2000	1999	1998
Non-accrual and restructured loans	\$458	\$1,102	\$719	\$618	\$854
Foreclosed assets	0	75	13	85	0
Loans past-due 90 days or more and still accruing	0	217	10	47	27
Total non-performing assets	<u>\$458</u>	<u>\$1,394</u>	<u>\$742</u>	<u>\$750</u>	<u>\$881</u>
Non-performing assets to period-end loans and foreclosed assets	.23%	.70%	.39%	.40%	.55%
Total non-performing assets to total assets	.10%	.35%	.21%	.22%	.29%
Total allowance for loan losses to total non-performing assets	693.7%	209.6%	364.2%	346.6%	274.8%

There is a concentration of real estate mortgage loans in the loan portfolio. Real estate mortgages, including residential and commercial, comprise 75.0% of the loan portfolio as of December 31, 2002, up from 71.2% in 2001. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the real estate loan portfolio has a mix of both fixed rate and adjustable rate mortgages. The real estate loans are concentrated primarily in our marketing area and are subject to risks associated with the local economy.

DEPOSITS AND OTHER BORROWED FUNDS

Consumer and commercial retail deposits are attracted primarily by First Keystone's subsidiary bank's ten full service office locations. The Bank offers a broad selection of deposit products and continually evaluates its interest rates and fees on deposit products. The Bank regularly reviews competing financial institutions interest rates along with prevailing market rates, especially when establishing interest rates on certificates of deposit.

Deposits increased by \$36,064,000, or a 12.2% increase when comparing December 31, 2002, to December 31, 2001. This increase compares to a deposit increase of 8.5% in 2001 and an increase of 11.0% in 2000.

During 2002, the Corporation experienced a deposit increase in both non-interest bearing and interest bearing deposits. Non-interest bearing deposits increased to \$30,057,000 as of December 31, 2002, an increase of \$4,481,000, or 17.5% over 2001. Interest bearing deposits amounted to \$300,689,000 as of December 31, 2002, an increase of \$31,584,000, or 11.7% over 2001.

During 2002, the Corporation decreased its reliance on short-term borrowings. Short-term borrowings amounted to \$9,067,000 as of year-end 2002, a decrease of \$2,499,000 from 2001. Long-term borrowings increased \$500,000 in 2002 to \$45,750,000 as of December 31, 2002. Total borrowings were \$54,817,000 as of December 31, 2002, compared to \$56,816,000 on December 31, 2001. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, U.S. Treasury demand notes, and short-term borrowings from the Federal Home Loan Bank (FHLB).

Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more. Some of the additional term borrowings were made to take advantage of special rates offered by the FHLB. In connection with FHLB borrowings and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains on investment securities available-for-sale, net of taxes, increased shareholders' equity or capital in 2002, referred to as accumulated other comprehensive income. The total net increase in capital was \$9,400,000 in 2002 after an increase of \$3,038,000 in 2001. The accumulated other comprehensive income amounted to \$6,544,000 in 2002 and \$715,000 in 2001. One factor which decreased equity capital in 2002 and 2001 relates to our stock repurchase plan. The Corporation repurchased 119,181 shares of common stock as of December 31, 2002, and 100,000 shares in 2001, at a cost of \$3,577,000 and \$3,097,000, respectively.

Return on equity (ROE) is computed by dividing net income by average stockholders' equity. This ratio was 14.93% for 2002, 13.85% for 2001, and 16.55% for 2000. Refer to Performance Ratios on Page 2 - Summary of Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 11 reflects risk-based capital ratios and the leverage ratio for our Corporation and Bank. The Corporation's leverage ratio was 9.78% at December 31, 2002, and 9.79% at December 31, 2001.

The Corporation has consistently maintained regulatory capital ratios at or above the "well capitalized" standards. For additional information on capital ratios, see Note 14 to the Consolidated Financial Statements. The risk-based capital ratios also decreased somewhat in 2002 from 2001 for both the Corporation and the Bank, but remain strong. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments. Table 11 indicates capital ratios as of December 31, 2002.

Table 11 • Capital Ratios

	December 31, 2002		December 31, 2001	
	Corporation	Bank	Corporation	Bank
Risk-Based Capital:				
Tier I risk-based capital ratio	15.80%	15.33%	15.01%	14.41%
Total risk-based capital ratio (Tier 1 and Tier 2)	17.11%	16.52%	16.26%	15.54%
Leverage Ratio:				
Tier I capital to average assets	9.78%	9.48%	9.79%	9.42%

LIQUIDITY MANAGEMENT

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as the operating cash needs of the Corporation, are met.

Liquidity is needed to provide the funding requirements of depositors withdrawals, loan growth, and other operational needs. Asset liquidity is provided by investment securities maturing in one year or less, other short-term investments, federal funds sold, and cash and due from banks. At year-end 2002, cash and due from banks and interest-bearing deposits in other banks totaled \$7,456,000 as compared to \$6,550,000 at year-end 2001. Additionally, maturing loans and repayment of loans are another source of asset liquidity.

Liability liquidity is accomplished by maintaining a core deposit base, acquired by attracting new deposits and retaining maturing deposits. Also, short-term borrowings provide funds to meet liquidity.

Management feels its current liquidity position is satisfactory given the fact that the Corporation has a very stable core deposit base which has increased annually. Secondly, our loan payments and principal paydowns on our mortgage backed securities provide a steady source of funds. Also, short-term investments and maturing investments represent additional sources of liquidity.

Finally, the Corporation's subsidiary bank does have access to funds on a short-term basis from the Federal Reserve Bank discount window. Also, Fed funds can be purchased by means of a borrowing line at the Atlantic Central Bankers Bank. The Corporation has indirect access to the capital markets through its membership in the Federal Home Loan Bank. Advances on borrowings, both short-term and long-term, are available to help address any liquidity needs.

FORWARD LOOKING STATEMENTS

The sections that follow, Market Risk Management and Asset/Liability Management contain certain forward looking statements. These forward looking statements involve significant risks and uncertainties, including changes in economic and financial market conditions. Although First Keystone Corporation believes that the expectations reflected in such forward looking statements are reasonable, actual results may differ materially.

MARKET RISK MANAGEMENT

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. First Keystone Corporation's market risk is composed primarily of interest rate risk. The Corporation's interest rate risk results from timing differences in the repricing of assets, liabilities, off-balance sheet instruments, and changes in relationships between ratio indices and the potential exercise of explicit or embedded options.

Increases in the level of interest rates also may adversely affect the fair value of the Corporation's securities and other earning assets. Generally, the fair value of fixed-rate instruments fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of the Corporation's interest-earning assets, which could adversely affect the Corporation's results of operations if sold, or, in the case of interest earning assets classified as available for sale, the Corporation's stockholders' equity, if retained. Under The Financial Accounting Standards Board (FASB) Statement 115, changes in the unrealized gains and losses, net of taxes, on securities classified as available for sale will be reflected in the Corporation's stockholders' equity. As of December 31, 2002, the Corporation's securities portfolio included \$209,823,000 in securities classified as available for sale. Accordingly, with the magnitude of the Corporation's holdings of securities available for sale, changes in interest rates could produce significant changes in the value of such securities and could produce significant fluctuations in the stockholders' equity of the Corporation. The Corporation does not own any trading assets.

ASSET/LIABILITY MANAGEMENT

The principal objective of asset liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 12 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (December 31, 2002 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year.

In Table 12, the Corporation has elected to incorporate interest bearing demand deposits, money market accounts, and savings deposits as rate sensitive based upon prior experience and assumed withdrawal rates. The result is that First Keystone Corporation is liability sensitive in the one year time frame and asset sensitive in the one to five year time frame. While the Corporation feels it is liability sensitive out to a year, its exposure to an increase in interest rates is limited within policy guidelines. As discussed previously, being liability sensitive will decrease net interest income should interest rates rise. Despite the Corporation's liability sensitivity, the impact of a rapid rise in interest rates as occurred in 1994 and 1999, did not have a significant effect on our net interest income.

Table 12 • Interest Rate Sensitivity Analysis

(Amounts in thousands)	December 31, 2002				
	One Year	1 - 5 Years	Beyond 5 Years	Not Rate Sensitive	Total
Loans	\$ 83,920	\$ 101,575	\$ 16,022	\$ 0	\$ 201,517
Investments	31,825	103,274	80,656	0	215,755
Other interest-earning assets	10,162	0	0	0	10,162
Total Rate Sensitive Assets	\$ 125,907	\$ 204,849	\$ 96,678	\$ 0	\$ 427,434
Non-earning assets	\$ 0	\$ 0	\$ 0	\$ 15,267	\$ 15,267
Allowance for loan losses	0	0	0	(3,175)	(3,175)
Total Assets	\$ 125,907	\$ 204,849	\$ 96,678	\$ 12,092	\$ 439,526
Interest-bearing deposits	\$ 121,938	\$ 88,185	\$ 90,568	\$ 0	\$ 300,691
Borrowed funds	10,567	8,000	36,250	0	54,817
Total Rate Sensitive Liabilities	\$ 132,505	\$ 96,185	\$ 126,818	\$ 0	\$ 355,508
Demand Deposits	\$ 0	\$ 0	\$ 0	\$ 30,054	\$ 30,054
Other Liabilities	0	0	0	4,868	4,868
Stockholders' equity	0	0	0	49,096	49,096
Total Liabilities and Stockholders' Equity	\$ 132,505	\$ 96,185	\$ 126,818	\$ 84,018	\$ 439,526
Interest rate sensitivity gap	\$ (6,598)	\$ 108,664	\$ (30,140)		\$ 71,926
Cumulative gap	\$ (6,598)	\$ 102,066	\$ 71,926		

Earnings at Risk

The Bank's Asset/Liability Committee (ALCO) is responsible for reviewing the interest rate sensitivity position and establishing policies to monitor and limit exposure to interest rate risk. The guidelines established by ALCO are reviewed by the Corporation's Board of Directors. The Corporation recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond interest rate sensitivity gap. Although the Corporation continues to measure its interest rate sensitivity gap, the Corporation utilizes additional modeling for interest rate risk in the overall balance sheet. Earnings at risk and economics value at risk are analyzed.

Earnings simulation modeling addresses earnings at risk and net present value estimation addresses economic value at risk. While each of these interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Corporation.

Earnings Simulation Modeling

The Corporation's net income is affected by changes in the level of interest rates. Net income is also subject to changes in the shape of the yield curve. For example, a flattening of the yield curve would result in a decline in earnings due to the compression of earning asset yields and funds rates, while a steepening would result in increased earnings as investment margins widen.

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under an increase and decrease of 200 basis points in the interest rate earnings simulation model.

Table 13 presents an analysis of the changes in net-interest income and net present value of the balance sheet resulting from an increase or decrease of two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net-interest income would increase by approximately 2.66% if rates fell by two percentage points over one year. The model projects a decrease of approximately 8.51% in net-interest income if rates rise by two percentage points over one year. Both of these forecasts are within the one year policy guidelines.

Net Present Value Estimation

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into

account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At year-end, a 200 basis point immediate decrease in rates is estimated to increase net present value by 14.15%. Additionally, net present value is projected to decrease by 12.61% if rates increase immediately by 200 basis points, both within policy guidelines. During 2002, the Corporation's interest rate risk position grew less liability sensitive. If management is concerned market interest rates may begin to rise in 2003, it can take steps to reduce liability sensitivity by attracting long-term deposits and reducing short-term borrowings.

The computation of the effects of hypothetical interest rate changes are based on many assumptions. They should not be relied upon solely as being indicative of actual results, since the computations do not contemplate actions management could undertake in response to changes in interest rates.

Table 13 • Effect of Change in Interest Rates

	Projected Change
Effect on Net Interest Income	
1-year Net Income simulation Projection	
-200 bp Shock vs Stable Rate	2.66%
+200 bp Shock vs Stable Rate	(8.51%)
Effect on Net Present Value of Balance Sheet	
Static Net Present Value Change	
-200 bp Shock vs Stable Rate	14.15%
+200 bp Shock vs Stable Rate	(12.61%)

MARKET PRICE/DIVIDEND HISTORY

As of December 31, 2002, the corporation had 2,955,999 shares of \$2.00 par value common stock outstanding held by shareholders of record. First Keystone Corporation's common stock is quoted on the Over The Counter (OTC) Bulletin Board under the symbol "FKYS".

Table 14 reports the highest and lowest per share prices known to the Corporation and the dividends paid during the periods indicated. The market prices and dividend paid have been adjusted to reflect the 5% stock dividend paid August 6, 2002. These prices do not necessarily reflect any dealer or retail markup, markdown or commission.

Table 14 • Market Price/Dividend History

	2002		2001		2000	
	Common Stock High/Low	Dividends Paid	Common Stock High/Low	Dividends Paid	Common Stock High/Low	Dividends Paid
First Quarter	\$22.86/\$18.57	\$.20	\$15.95/\$12.86	\$.19	\$20.24/\$16.67	\$.18
Second Quarter	\$22.38/\$20.10	.20	\$18.10/\$13.70	.19	\$18.57/\$16.90	.18
Third Quarter	\$24.00/\$19.19	.21	\$25.24/\$17.38	.19	\$17.38/\$16.19	.18
Fourth Quarter	\$26.25/\$23.95	.24	\$20.18/\$18.10	.20	\$16.31/\$15.12	.19

The following brokerage firms make a market in First Keystone Corporation stock:

Legg Mason Wood Walker, Inc.
1735 Market Street, 10th Floor
Mellon Bank Center
Philadelphia, PA 19103
(800) 888-6673

Janney Montgomery Scott, Inc.
1801 Market Street
Philadelphia, PA 19103
(800) 526-6397

Ryan, Beck and Company
Millenium One
20 Ash Street, 4th Floor
Conshohocken, PA 19428
(800) 223-6807

*F. J. Morrissey & Co./
Boenning & Scattergood, Inc.*
4 Tower Bridge, Suite 1420
West Conshohocken, PA 19428
(800) 842-8928

Ferris Baker Watts, Inc.
3100 Market Street
Camp Hill, PA 17011
(800) 638-7411

Table 15 • Quarterly Results of Operations (Unaudited)

(Amounts in thousands, except per share)

	Three Months Ended			
	March 31	June 30	September 30	December 31
2002				
Interest income	\$ 6,392	\$ 6,465	\$ 6,583	\$ 6,422
Interest expense	<u>2,712</u>	<u>2,643</u>	<u>3,069</u>	<u>2,918</u>
Net interest income	\$ 3,680	\$ 3,822	\$ 3,514	\$ 3,504
Provision for loan losses	175	125	125	125
Other non-interest income	515	465	548	757
Non-interest expense	<u>1,816</u>	<u>1,905</u>	<u>1,992</u>	<u>2,098</u>
Income before income taxes	\$ 2,204	\$ 2,257	\$ 1,945	\$ 2,038
Income taxes	<u>532</u>	<u>538</u>	<u>397</u>	<u>390</u>
Net income	<u>\$ 1,672</u>	<u>\$ 1,719</u>	<u>\$ 1,548</u>	<u>\$ 1,648</u>
Per share	\$.56	\$.58	\$.52	\$.56
2001				
Interest income	\$ 6,697	\$ 6,776	\$ 6,736	\$ 6,627
Interest expense	<u>3,880</u>	<u>3,849</u>	<u>3,578</u>	<u>3,158</u>
Net interest income	\$ 2,817	\$ 2,927	\$ 3,158	\$ 3,469
Provision for loan losses	100	85	100	325
Other non-interest income	481	564	531	770
Non-interest expense	<u>1,701</u>	<u>1,823</u>	<u>1,776</u>	<u>1,880</u>
Income before income taxes	\$ 1,497	\$ 1,583	\$ 1,813	\$ 2,034
Income taxes	<u>294</u>	<u>339</u>	<u>406</u>	<u>455</u>
Net income	<u>\$ 1,203</u>	<u>\$ 1,244</u>	<u>\$ 1,407</u>	<u>\$ 1,579</u>
Per share	\$.40	\$.42	\$.48	\$.53

FIRST KEYSTONE CORPORATION

DIRECTORS*

John Arndt

Owner, Arndt Insurance Agency

J. Gerald Bazewicz

President and Chief Executive Officer of the Corporation and the Bank

Budd L. Beyer

Retired

Don E. Bower

President, Don E. Bower, Inc.

Robert E. Bull

Chairman of the Corporation and the Bank

Retired; Attorney, Bull, Bull & Knecht, LLP

John L. Coates

Secretary of the Corporation and the Bank

President, Tri-County Hardware, Inc.

Dudley P. Cooley

Financial Consultant;

Former Controller, Wise Foods, Borden, Inc.

Frederick E. Crispin, Jr.

Retired; Former Business and Financial Consultant, F. E. Crispin and Associates

Jerome F. Fabian

Owner/President, Tile Distributors of America, Inc.

Robert J. Wise

Vice Chairman of the Corporation and the Bank

Retired

**Also Directors of The First National Bank of Berwick*

OFFICERS

Robert E. Bull

Chairman

Robert J. Wise

Vice Chairman

J. Gerald Bazewicz

President and Chief Executive Officer

David R. Saracino

Treasurer and Assistant Secretary

John L. Coates

Secretary

THE FIRST NATIONAL BANK OF BERWICK

OFFICERS

Robert E. Bull

Chairman of the Board

Robert J. Wise

Vice Chairman of the Board

J. Gerald Bazewicz

President and Chief Executive Officer

since January 1987

with the Bank since February 1973

32 years in banking

David R. Saracino

Vice President, Cashier and

Assistant Secretary

since January 1987

with the Bank since February 1972

30 years in banking

Leslie W. Bodle

Vice President and Trust Officer

since October 1985

with the Bank since October 1985

37 years in banking

Timothy K. Kishbach

Vice President and Senior Loan Officer

since October 2001

with the Bank since September 1989

15 years in banking

Robert D. McWilliams

Assistant Vice President and Loan

Administration Manager

since March 1989

with the Bank since September 1973

29 years in banking

Barbara J. Robbins

Assistant Vice President and

Data/Deposit Operations Manager

since April 1990

with the Bank since June 1970

32 years in banking

Linda K. Yerges

Assistant Vice President and Human

Resources Manager

since April 1993

with the Bank since January 1973

29 years in banking

Gabriel D. Alessi

Assistant Vice President and Mortgage Officer

since May 1995

with the Bank since May 1995

29 years in banking

Leona Luongo

Assistant Vice President and

Wilkes-Barre Area Sales Manager

since August 1998

with the Bank since August 1998

36 years in banking

Evelyn M. Bower

Assistant Vice President and

Loan Review Officer

since April 1999

with the Bank since March 1978

26 years in banking

Carmie A. Cleaver

Assistant Vice President and Sales Division

Manager/ Branch Administrator

since February 2002

with the Bank since May 1972

30 years in banking

Diane C. A. Rosler

Assistant Vice President and Accounting

Manager

since April 1994

with the Bank since July 1990

12 years in banking

Douglas E. Klinger

Assistant Vice President and Commercial Loan

Officer

since April 1995

with the Bank since August 1993

9 years in banking

Judith A. Gizenski

Trust Officer

since August 1991

with the Bank since June 1976

26 years in banking

Marlene L. Eckrote

Trust Officer

since April 2001

with the Bank since September 1972

30 years in banking

THE FIRST NATIONAL BANK OF BERWICK

OFFICERS (continued)

James Szewc

Trust Investment Officer
since August 1998
with the Bank since August 1998
4 years in banking

Kevin L. Miller

Assistant Cashier and EDP Manager
since April 1991
with the Bank since November 1982
20 years in banking

Richard L. Holloway

Assistant Cashier and Community Office
Manager, Salem Office
since April 1994
with the Bank since September 1983
19 years in banking

Tina M. Gray

Assistant Cashier and Community Office
Manager, Freas Avenue Office
since April 1995
with the Bank since June 1984
28 years in banking

Lee Hess

Assistant Cashier and Security Officer
since April 1996
with Bank since December 1991
11 years in banking

Sherri A. Sittler

Assistant Cashier and Deposit Processing
Supervisor
since April 1997
with Bank since September 1980
22 years in banking

Jodi L. Alley

Assistant Cashier and Loan Processing
Supervisor
since April 1997
with Bank since February 1991
20 years in banking

Moirá Dalton

Trust Business Development Officer
since April 1999
with Bank since August 1997
9 years in banking

Tammy Dietterick

Assistant Cashier and Community Office
Manager, Nescopeck Office
since April 2000
with Bank since July 1985
18 years in banking

Frank Crayton

Assistant Cashier and Community Office
Manager, Mifflinville Office
since April 2000
with Bank since December 1986
16 years in banking

Donna Keefer

Assistant Cashier and Training/Bank Secrecy
Officer
since April 2002
with Bank since June 1978
24 years in banking

John L. Coates

Secretary

Kingston,

Pennsylvania

In August 2002, The First National Bank of Berwick opened its tenth branch office at 179 South Wyoming Avenue in Kingston, Pennsylvania. The office offers a full range of banking services, as well as mortgage, trust and investment services.

Our staff is dedicated to building strong, long-term relationships by providing every customer with the highest quality of service and products.



Pictured left to right: Anna Mae Mariani, Todd Serafin, Kelly Graham, Sydney Walker, Angelo Bufalino



Anna Mae Mariani, Branch Manager, exemplifies the friendly, high quality service found at all our branch offices



Attention to the customer is top priority for Angelo Bufalino, Customer Service



Todd Serafin, Commercial Services Officer, stands ready to meet all your business needs

THE FIRST NATIONAL BANK OF BERWICK

OFFICE LOCATIONS

Berwick

① Main Office
111 West Front Street
Berwick, PA 18603
(570) 752-3671

② 400 Fowler Avenue
Berwick, PA 18603
(570) 759-2628

③ 701 Freas Avenue
Berwick, PA 18603
(570) 752-1244

④ Giant Market
50 Briar Creek Plaza
Berwick, PA 18603
(570) 802-0541

Bloomsburg

⑤ Central Road and Route 11
Bloomsburg, PA 17815
(570) 784-0354

Danville

⑥ Giant Market
328 Church Street
Danville, PA 17821
(570) 271-3100

Mifflinville

⑦ Third and Race Streets
Mifflinville, PA 18631
(570) 752-5750

Nescopeck

⑧ 437 West Third Street
Nescopeck, PA 18635
(570) 759-2767

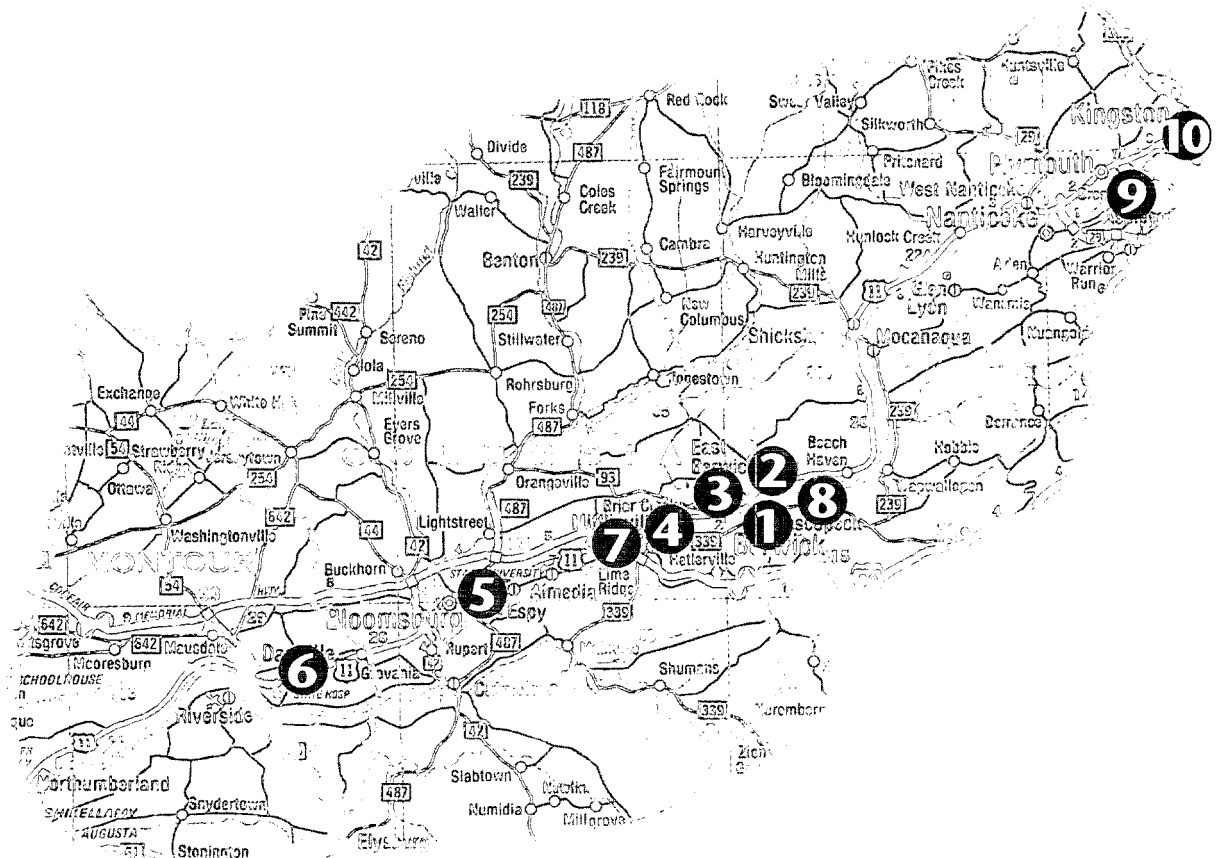
Wilkes-Barre

⑨ Hanover Township
1540 Sans Souci Highway
Wilkes-Barre, PA 18706
(570) 825-7352

Kingston

⑩ 179 South Wyoming Avenue
Kingston, PA 18704
(570) 718-1110

Toll Free: 1-888-759-2266
www.firstnationalberwick.com



Common Stock Listing

First Keystone Corporation common stock is traded on the Over the Counter (OTC) Bulletin Board under the symbol "FKYS".

Direct Deposit of Dividends

Shareholders may have their cash dividends deposited directly into the account of their choice at any banking institution, with no charge. Additional information and enrollment materials for direct deposit can be obtained by calling 570-752-3671, extension 175 (locally), or 1-888-759-2266.

Dividend Reinvestment and Stock Purchase Plan

The Plan, open to residents of Pennsylvania, provides the opportunity to have dividends automatically reinvested into First Keystone Corporation stock. Participants in the Plan may also elect to make cash contributions to purchase additional shares of common stock. For information regarding the Plan, contact the Plan Administrator by writing to:

The First National Bank of Berwick
Plan Administrator
111 West Front Street
P.O. Box 289
Berwick, Pennsylvania 18603

Or telephone: 570-752-3671, extension 175 (locally), or 1-888-759-2266

Shareholder Assistance

If you need assistance to change or transfer registration of your stock certificate, to report a lost certificate, or other related inquiries, please contact our transfer agent by writing to:

The First National Bank of Berwick
Attention: Shareholder Services
111 West Front Street
P.O. Box 289
Berwick, Pennsylvania 18603

Or telephone: 570-752-3671, extension 175 (locally), or 1-888-759-2266

Internet

Information regarding First Keystone Corporation and its principal subsidiary, The First National Bank of Berwick, is available on the Internet at www.firstnationalberwick.com. Our Email address is fnb@fnbbwk.com.